Senior Secondary Course

ACCOUNTANCY (320)

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NIOS SENIOR SECONDARY - ACCOUNTANCY (320)

Complete Textbook (38 Lessons)

Table of Contents

1. Accounting - An Introduction 4
2. Accounting Concepts 26
3. Accounting Conventions and Standards 41
4. Accounting for Business Transactions 53
5. Journal 83
6. Ledger 106
7. Cash Book 123
8. Special Purpose Books 148
9. Trial Balance 172
10. Bank Reconciliation Statement 192
11. Bills of Exchange 206
12. Errors and their Rectification 228
13. Computer and Computerised Accounting System 246
14. Depreciation 273
15. Provision and Reserves 303
16. Financial Statements - An Introduction 315
17. Financial Statements - I 343
18. Financial Statements II 366
19. Not for Profit Organisations - An Introduction 406
20. Financial Statements (Not for Profit Organisations 421
21. Accounts From Incomplete Records 442
22. Partnership - An Introduction 469
23. Admission of a Partner 511
24. Retirement and Death of a Partner 578
25. Dissolution of a partnership firm 613
26. Company - An Introduction 633
27. Issue of Shares 657
28. Forfeiture of Shares 691
29. Reissue of Forfeited Shares 710
30. Issue of Debentures 724
31. Financial Statements Analysis-An Introduction 758
32. Accounting Ratios-I 788
33. Accounting Ratios-II 809
34. Cash Flow Statement 822
35. Electronic Spread Sheet 853
36. Use of Spread-sheet in Business Application 887
37. Graphs and Charts for Business 899
38. Database Management System for Accounting 914

ACCOUNTANCY (320) - SYLLABUS BIFURCATION

Chapter split as per NIOS Bifurcation of Syllabus

TMA (Tutor Marked Assignment) (11 lessons)

1. Accounting - An Introduction 4
2. Cash Book 123
3. Special Purpose Books 148
4. Trial Balance 172
5. Depreciation 273
6. Provision and Reserves 303
7. Partnership - An Introduction 469
8. Company - An Introduction 633
9. Issue of Debentures 724
10. Financial Statements Analysis-An Int 758
11. Electronic Spread Sheet 853

Public Examination (18 lessons)

1. Journal 83
2. Ledger 106
3. Errors and their Rectification 228
4. Computer and Computerised Accounting 246
5. Financial Statements - An Introducti 315
6. Financial Statements - I 343
7. Financial Statements II 366
8. Not for Profit Organisations - An In 406
9. Financial Statements (Not for Profit 421
10. Retirement and Death of a Partner 578
11. Dissolution of a partnership firm 613
12. Issue of Shares 657
13. Forfeiture of Shares 691
14. Reissue of Forfeited Shares 710
15. Cash Flow Statement 822
16. Use of Spread-sheet in Business Appl 887
17. Graphs and Charts for Business 899
18. Database Management System for Accou 914

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ACCOUNTING - AN INTRODUCTION

Whenever your mother asks you to go to the nearby grocery store to buy items of daily use like match box, candle stick, soap cake, coffee, spices etc. you need not pay for these items immediately. When you buy these items, the store owner immediately opens the page of a note book on which your father's name is written. He records the value of items purchased. At the end of the month, your father goes to him. He again opens the same page tells the total amount to be paid and records when your father makes the payment. In a similar manner, he keeps the record of other customers also. Whenever he gets commodities from suppliers he records the same and also records the payment he makes to them. Similarly, every business small or big, sole proprietor or a firm keeps the record of the business transactions. Have you ever thought why do they keep record of business transactions? If they do not keep the record how will they know how much, when and to whom they have to make payments or from whom, how much and when they have to receive payments or what they have earned after a particular period and so on. Recording of transactions by a businessman in proper books and in a systematic manner is known as accounting. In this lesson you will learn about this in detail.

OBJECTIVES

After studying this lesson you will be able to

- explain the meaning of Book-Keeping;
- state the meaning and nature of accounting;
- distinguish between book keeping and accounting;
- explain the advantages & limitations of accounting;
- explain the branches of accounting;

- state the functions and objectives of financial accounting;
- explain accounting as an information system for decision making by the interested users and
- explain various accounting terms.

Notes

1.1 BOOK KEEPING AND ACCOUNTING

A business undertakes number of transactions. Can you estimate the number of transactions a business undertakes? It depends upon the size of a business entity. Every day business transactions may be around hundreds/thousands. Can a businessman remember all these transactions in every respect? Not at all. So it becomes necessary to record these business transactions in details and in a systematic manner. Recording of business transactions in a systematic manner in the books of account is called book-keeping. Book-Keeping is concerned with recording of financial data. This may be defined as.

> "The art of keeping a permanent record of business transactions is book-keepng".

From books of accounts important details such as total sales, total purchases, total cash receipts, total payments, etc. may be ascertained. As you know the main objective of business is to earn profits. In order to ascertain the profit earned during a period, mere recording of business transactions is not enough. Accounting involves not only book keeping but also many other activities. In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as

> "The art of recording, classifying, summarising, analysing and interpreting the business transactions systematically and communicating business results to interested users in accounting"

Accounting is identified with a system of recording of business transactions that create economic information about business enterprises to facilitate decision making. The function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.

The American Accounting Association defined accounting as :

> "It is the process of identifying, measuring, recording and communicating the required information relating to the economic events of an organisation to the interested users of such information.

In order to appreciate the nature of accounting it is necessary to understand the following relevant aspects of the definition of accounting:

- **Economic events :** It is the occurring of the consequence to a business organisation which consists of transactions that are measurable in monetary terms. Purchase of a Machinery, installing and keeping it ready for manufacturing is an economic event which consists of a number of financial transactions. These transactions are (a) buying the machine, (b) transporting the same, (c) preparing the site for its installation and (d) incurring expenditure on installing the same.

- **Identification, Measurement, Recording and Communication :**

  Identification implies determining what transactions are to be recorded i.e. items of financial character are to be recorded. For example, goods purchased for cash or on credit will be recorded. Items of non-financial character such as changes in managerial policies, etc. are not recorded in the books of accounts.

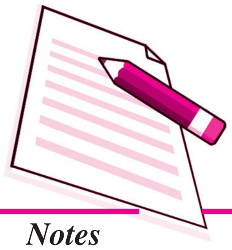
  Measurement means quantification of business transactions into financial terms by using monetary unit. If an event cannot be quantified in monetary terms, it is not considered fit for recording in the books of the firm. That is why important items like appointment, signing of contracts, etc. are not shown in the books of accounts.

  Recording : Having identified and measured the economic events in financial terms, these are recorded in the books of accounts in monetary terms date wise. The recording of the business transactions is done in such a manner that the necessary financial information is summarized according to well established accounting practices.

  Communication : The economic events are identified, measured and recorded in such a manner that the necessary relevant information is generated and communicated in a certain form to the management and other internal and external users of information. The financial information is regularly communicated through accounting reports.

- **Organisation :** refers to a business enterprise whether for profit or not for profit motive.

- **Interested users of information.** Many **users** need financial information to make important decisions. These users can be investors, creditors, labour unions, Trade Associations, etc.



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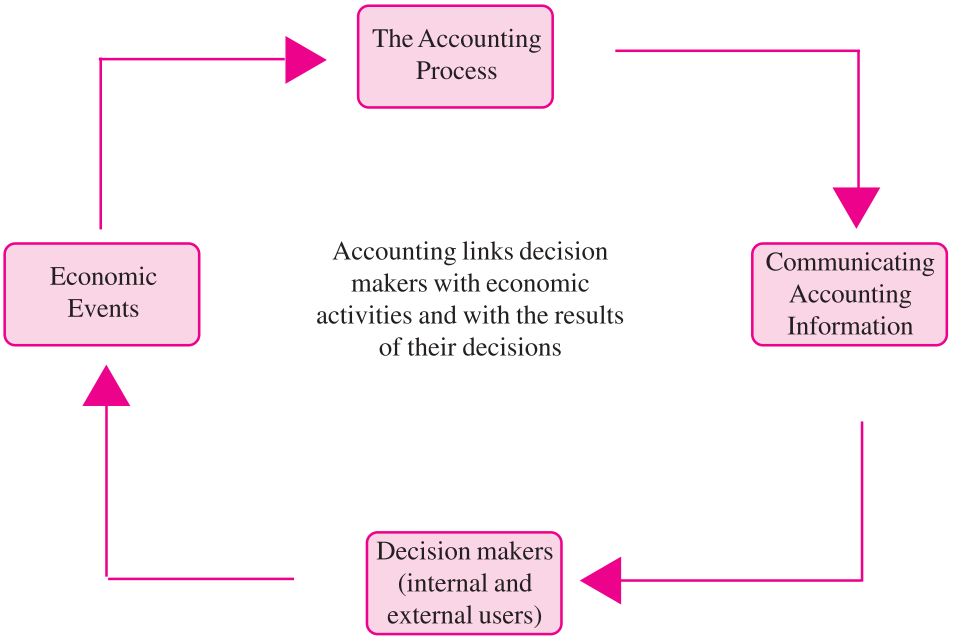
Evolution of Accounting

As per Indian mythology Chitra Gupta is responsible for maintaining accounts in God's court.

A book on Arthashasthra written by Kautilya who was a minister in Chandra Gupta's kingdom twenty three centuries ago mentions about the accounting practices in India. It describes how accounting records have to be maintained. In China and in Egypt accounting was used for maintaining revenue records of the government treasury.

A book on Arithmetica Geometrica, Proportion at Proportionality (Review of Arithmetic and Geometric proportion) by an Italian Luca Pacioli is considered as the first authentic book on double entry book keeping. In his book he used the present day popular terms of accounting Debit (Dr.) and Credit (Cr). He also discussed the details of memorandum, journal, ledger and specialised accounting procedures. He also stated that, "all entries have to be double entries, i.e. if you make one creditor you must make some debtor.

Accounting process can be summarised as



Accounting Process

Difference between book keeping and accounting : Book keeping and accounting can be differentiated on the basis of nature, objective, function, basis, level of knowledge, etc.

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Difference between Book Keeping and Accounting

Basis of Difference	Book-keeping	Accounting
Nature	It is concerned with identifying financial transactions; measuring them in monetary terms; recording and classifying them.	It is concerned with summarizing the recorded transactions, interpreting them and communicating the results.
Objective	It is to maintain systematic records of financial transactions.	It aims at ascertaining business income and financial position by maintaining records of business transactions.
Function	It is to record business transactions. So its scope is limited.	It is the recording, classifying, summarizing, interpreting business transactions and communicating the results. Thus its scope is quite wide.
Basis	Vouchers and other supporting documents are necessary as evidence to record the business transactions.	Book-keeping works as the basis for accounting information.
Level of Knowledge	It is enough to have elementary knowledge of accounting to do book-keeping.	For accounting, advanced and in-depth knowledge and understanding is required.
Relation	Book-keeping is the first step to accounting.	Accounting begins where book-keeping ends.

INTEXT QUESTIONS 1.1

I. Fill in the blanks with suitable word/words:

i. Keeping systematic record of business transactions is known as ____________.

ii. The next step after classification of recorded transactions is ____________.

iii. The whole process of recording, classifying, summarizing and interpreting the business transactions systematically and communicating business results to the interested users of financial information is known as ____________.

iv. Interested users of accounting information are ____________.

II. Identify transactions related to book-Keeping or accounting and write B for book-keeping and A for accounting against the space provided:

i. Credit Sales/Purchases (................)

ii. Cash Purchases/Sales (................)

iii. Calculation of business profits (................)

iv. Find out total debtors (................)

v. Find out financial position of the business enterprise (..................)

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1.2 BRANCHES AND OBJECTIVES OF ACCOUNTING

Branches of Accounting

The changing requirements of the business over the centuries have given rise to specialized branches of accounting and these are :

Financial Accounting

It is concerned with recording the transactions of financial character, summarising and interpreting them and communicating the results to the users. It ascertains profit earned or loss incurred during a period (usually one year as accounting year) and the financial position as on the date when the accounting period ends. It can provide financial information required by the management and other parties. The word accounting and financial accounting are used interchangeably. At present we are concerned with financial accounting only.

Cost Accounting

It analyses the expenditure so as to ascertain the cost of various products manufactured by the firm and fix the prices. It also helps in controlling the costs and providing necessary costing information to management for decision making.

Management Accounting

It is concerned with generating information relating to funds, cost and profits etc. This enables the management in decision making. Basically, it is meant to assist the management in taking rational policy decisions and to evaluate the impact of its decisions and actions and the performance of various departments.

Tax Accounting

This branch of accounting has grown in response to the difficult tax laws such as relating to income tax, sales tax etc. An accountant is required to be fully aware of various tax legislations.

Social Accounting

This branch of accounting is also known as social reporting or social responsibility accounting. It discloses the social benefits created and the costs incurred by the enterprise. Social benefits include such facilities as medical, housing, education, canteen, provident fund and so on while the social costs may include such matters as exploitation of employees, industrial interest, environment pollution, unreasonable terminations, social evils resulting from setting up industries etc.

Objectives and Functions of Financial Accounting

The main objectives of financial accounting are as under :

Finding out Various Balances

Systematic recording of business transactions provides vital information about various balances like cash balance, bank balance, etc.

Providing Knowledge of Transactions

Systematic maintenance of books provides the details of every transactions.

Ascertaining Net Profit or Loss

Summarisation in form of Profit and Loss Account provides business income over a period of time.

Depicting Financial Position

Balance sheet is prepared to depict financial position of business means what the business owns and what it owes to others.

Information to All Interested Users

After analysis and interpretation, business performance and position are communicated to the interested users.

Fulfilling Legal Obligations

Vital accounting information helps in fulfilling legal obligations e.g. sales tax, income tax etc.

Functions of Accounting

The function of accounting is to provide quantitative information primarily financial in nature about economic entities, which is intended to be useful in making economic decisions. Financial accounting performs the following major functions:

Maintaining SystematicRrecords

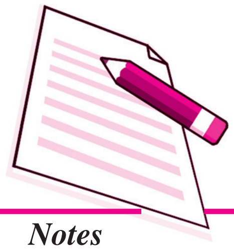
Business transactions are properly recorded, classified under appropriate accounts and summarized into financial statements.

Communicating the financial results

It is used to communicate financial information in respect of net profits (or loss), assets, liabilities etc. to the interested parties.

Meeting Legal Requirements

The provisions of various Laws such as Companies Act, 1956 Income Tax and Sales/ VAT Tax Acts, require the submission of various statements i.e. Annual accounts, Income Tax returns, Returns for VAT etc.



Fixing responsibility

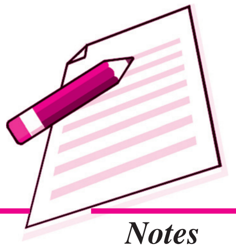
It helps in computation of profits of different departments of an enterprise. This facilitates the fixing of the responsibility of departmental heads.

Decision making

It provides the users the relevant data to enable them make appropriate decisions in respect of investment in the capital of the business enterprise or to supply goods on credit or lend money etc.

Advantages of Accounting

1. **Financial Information about Business :** Financial performance during the accounting period, *i.e.,* profit or loss and also the financial position at the end of the accounting period is known through accounting.
2. **Assistance of Management :** The management makes business plans, takes decision and exercise control on affairs on the basis of accounting information.
3. **Replace Memory :** A systematic and timely recording of transactions obviates the necessity to remember the transactions. The accounting record provides this necessary information.
4. **Facilitates Comparative Study :** A systematic record enables a businessman to compare one year's results with those of other years and locate significant factors leading to the change, if any.
5. **Facilitates Settlement of Tax Liabilities :** A systematic accounting record immensely helps settlement of income tax, sales tax, VAT and excise duty liabilities since it is a good evidence of the correctness of transactions.
6. **Facilitates Loans :** Loan is granted by the banks and financial institutions on the basis of growth potential which is supported by the performance. Accounting makes available the information with respect to performance.
7. **Evidence in Court :** Systematic record of transactions is often accepted by the Courts as good evidence.
8. **Facilitates Sale of Business :** If someone desires to sell his business, the accounts maintained by him will enable the ascertainment of the proper purchase price.
9. **Assistance in the Event of Insolvency :** Insolvency proceedings involve explaining many transactions that have taken place in the past. Systematic accounting records assist a great deal in such a situation.



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10. Helpful in Partnership Accounts : At the time of admission of a partner, retirement or death of a partner and dissolution of the firm, accounting records are of vital importance and use. It is so because such records provide the basis to reach a settlement.

Limitations of Accounting

1. **Accounting information is expressed in terms of Money :** Non-monetary events or transactions are completely omitted.

2. **Fixed assets are recorded in the accounting records at the original cost :** Actual amount spent on the assets like building, machinery, plus all incidental charges is recorded. In this way the effect of rise in prices is not taken into consideration. As a result the Balance Sheet does not represent the true financial position of the business.

3. **Accounting information is sometimes based on estimates:** Estimates are often inaccurate. For example, it is not possible to predict the actual life of an asset for the purpose of depreciation.

4. **Accounting information cannot be used as the only test of managerial performance on the basis of mere profits :** Profit for a period of one year can readily be manipulated by omitting certain expenses such as advertisement, research and development, depreciation etc. i.e. window dressing is possible.

5. **Accounting information is not neutral or unbiased :** Accountants ascertain income as excess of revenue over expenses. But they consider selected revenue and expenses for calculating profit of the concern. They also do not include cost of such items as water, noise or air pollution i.e. social cost, they may also use different methods of valuation of stock or depreciations.

INTEXT QUESTIONS 1.2

I. Following are the statements relating to various branches of accounting. Write against each the name of the branch of accounting to which the same belongs:

   i. It analyses the expenditure so as to ascertain the cost of products manufactured by the concern.

   ii. Accounting that discloses the social benefits and the costs incurred by the business enterprises.

iii. Accounting that is concerned with generating information that will enable the management in decision making.

II. How each of the following statements is a limitation of accounting?

i. Fixed assets are recorded in the accounting records at the original cost.

ii. Accounting information is sometimes based on estimates.

iii. Accounting information cannot be used as the only test of managerial performance on the basis of mere profit.

iv. Accounting information is expressed in terms of money.

III. How each of the following statements is an advantage of Accounting :

i. Evidence in Court

ii. Replaces Memory

iii. Financial Information about Business.

1.3 ACCOUNTING AS AN INFORMATION SYSTEM AND ITS USERS

In 1970, the Accounting Principles Board of The American Institute of certified Public Accountants (AICPA) emphasized that the function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions. Accounting is often called the **"Language of Business"**. It is the common language used to communicate financial information to individuals, organisations, government agencies about various aspects of business such as financial position, operating results (i.e. Profit or loss) and cash flows. **Users**, both inside and outside the business, have to make decisions concerning the allocation of limited economic resources. In order to ensure that resources are allocated in an efficient and effective manner, **users require financial information** for the purpose of making decisions. Accounting provides information that is useful in making business and economic decisions. It is the primary means of communicating financial information to owners, lenders, managers,. Government and its regulatory agencies '-and -others- who have interest in an enterprise. It helps the users in taking better decisions by providing relevant, reliable and timely information on the financial and operational position of an enterprise.

It is observed that almost all business enterprises maintain detailed accounting records. Even the most intelligent manager with a sharp memory would find it difficult to remember the daily transactions simply by observing them. So he/she must rely upon the accounting process which begins with the recording of business transactions and ends up with the preparation of summarized financial statements. Thus, Accounting as an information system is necessitated by great complexity of modern business organisations.

Accounting as a Source of Information

"Accounting is a service activity. It's function is to provide qualitive information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions."

As an information system, accounting collects data and communicates economic information about the organisation to a number of users whose decisions and actions are related to its performance. Accounting begins with the identification of transactions of financial nature and ends with the preparation of financial statements (*i.e.,* Income Statement and Balance Sheet). Each step in the process of accounting generates information. Generation of information is not an end in itself, it is a way to facilitate the dissemination of information among users of accounting information. Accounting information is used for predicting, comparing and evaluating the earning power and financial position of a business enterprise. Therefore, dissemination of information is an essential function of accounting.

INTEXT QUESTIONS 1.3

State whether the following statements are True or False :

i. Systematic record of transactions is often accepted by the Courts as good evidence.

ii. The balance sheet makes available the information about the financial health of the enterprises.

iii. Creditors are internal users of accounting information

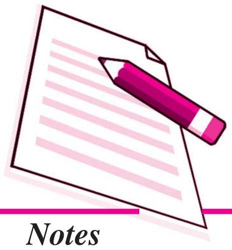
Users of Accounting Information

Users of Accounting Information may be categorised into Internal Users and External Users.

Internal Users

i. **Owners :** Owners contribute capital in the business and thus, are exposed to maximum risk. Naturally, they are interested in knowing the profit earned or loss suffered by the business besides the safety of their capital. The financial statements give the information about profit or loss and financial position of the business.

ii. **Management :** The management makes extensive use of accounting information to arrive at informed decisions such as determination of selling price, cost controls and reduction, investment into new projects, etc.



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iii. **Employees and Workers :** Employees and workers are entitled to bonus at the year end, which is linked to the profit earned by an enterprise. Therefore, the employees and workers are interested in financial statements. Besides, the financial statements also reflect whether the enterprise has deposited its dues into the provident fund and employees state insurance accounts, etc., or not.

External Users

i. **Banks and Financial Institutions :** Banks and financial institutions are an essential part of any business as they provide loans to the businesses. Naturally, they watch the performance of the business to know, whether it is making progress as projected to ensure the safety and recovery of the loan advanced. They assess it by analysing the accounting information.

ii. **Investors and Potential Investors :** Investment involves risk and also the investors do not have direct control over the business affairs. Therefore, they rely on the accounting information available to them and seek answers to the questions such as - what is the earning capacity of the enterprise and how safe is their investment?

iii. **Creditors :** Creditors are those parties who supply goods or services on credit. Before granting credit, creditors satisfy themselves about the credit worthiness of the business. The financial statements help them immensely in making such an assessment.

iv. **Government and Its Authorities :** The government makes use of financial statements to compile national income accounts and other informations. The information so available to it enables them to take policy decisions.

Government levies varied taxes such as Excise Duty, VAT, Service Tax and Income Tax. These government authorities assess the correct tax dues from an analysis of financial statements.

v. **Researchers :** Researchers use accounting information in their research work.

vi. **Consumers :** Consumers require accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of the prices of products they buy. Sometimes, prices of some products are fixed by the government, so it needs accounting information to fix fair prices so that consumers and producers are not exploited.

vii. **Public :** They want to see the business running since it makes substantial contribution to the economy in many ways, *e.g.*, employment of people, patronage to suppliers, etc. Thus, financial accounting provides useful financial information to various user groups for decision-making.

Qualitative Characteristics of Accounting Information

Two fundamental characteristics of financial statements are their truth and fairness. An auditor of the enterprise has to make a statement in his report whether, in his opinion, the financial statements give a true and fair view. It means that the Balance Sheet should give a true and fair view of the state of affairs and the Profit and Loss Account should give the true and correct profit or loss for the period. Besides the above fundamental characteristics, there are other qualitative characteristics (attributes) that make the information content of the financial statements meaningful to its users. There are:

1. Reliability;
2. Relevance;
3. Understandability and
4. Comparability.

Let us discuss these characteristics in detail:

1. Realiability : Accounting information must be reliable. the foremost factors that make it reliable are that

   i. it should be verifiable. It means, transactions should be evidenced by documents. For example, purchases be evidenced by bills of purchases, sales be evidenced by sales bills, etc.

   ii. it should be free from personal bias. It means, where personal judgement is to be exercised, it should be independent and free from bias.

   Reliability of the accounting information depends on:

   i. *Neutrality :* Neutrality means that the accounting information made available does not suffer from bias.

   ii. *Prudence :* The accounting information prepared on the principle of prudence (conservatism) means that the accounting information is prepared by providing all prospective losses while leaving all prospective profits.

   iii. *Completeness :* The accounting information given should be complete in all respects as incomplete information may lead to wrong interpretation.

   iv. *Substance Over Form :* The accounting information to be meaningful, should be governed by the substance of the information and not by its legal form alone.

2. Relevance : The accounting information, besides disclosing statutorily required disclosures, should disclose other informations, after judging its relevance to the

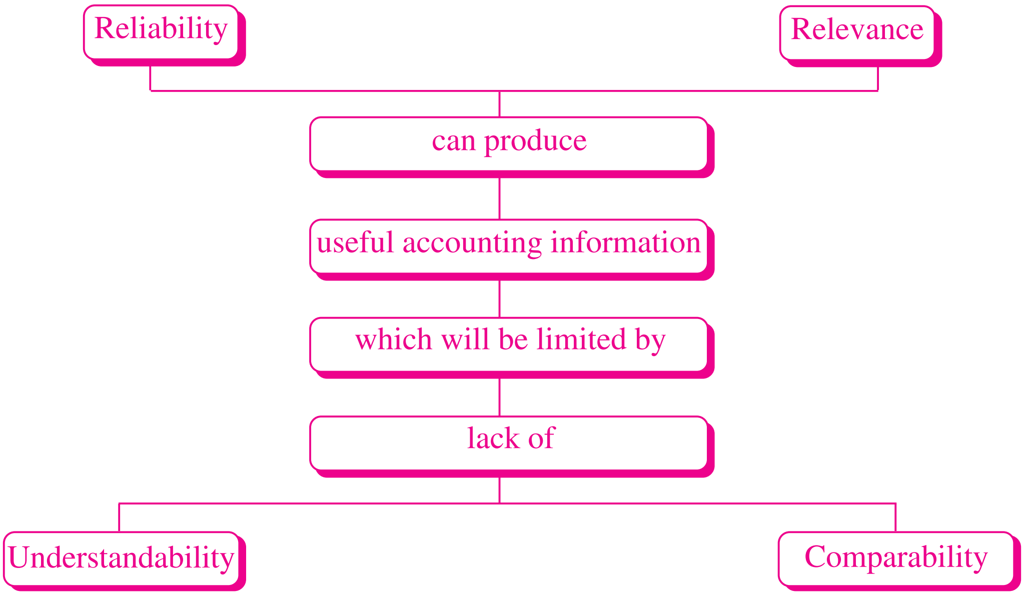
Notes

decision-making need of its users. For example, interest on borrowings is disclosed without stating the rate of interest. Users, therefore, cannot link interest cost to different types of borrowed funds. In the process, they fail to appreciate the rationality of financing decisions. Generally, only the statutory (legal) required information is disclosed. The information disclosure requirements are set after a public debate reflecting the views of cross-sections of users. But, what is relevant information in a particular circumstance cannot be generalised and specified. The management of the enterprise is in the best position to decide the contents of the information. It may be noted that relevance of the information is always guided by the principle of materiality.

3. **Understandability :** Understandability means that the information provided through the financial statements be presented in a manner that the users are able to understand it in the manner it should be. However, if an information is considered relevant for the users' decision-making it must be disclosed even if the information is complex and not readily understandable by common users. The information disclosure requirement of law must be fulfilled howsoever complex such information may be.

4. **Comparability :** Comparability means that the users should be able to compare the accounting information of an enterprise of the period either with that of other periods, known as intra-firm comparison or with the accounting information of other enterprises, known as inter-firm comparison. It is, therefore, necessary to follow standardised accounting policies consistently to the extent possible.

Accounting information to be useful should have all the above characteristics. The accounting information produced in the light of Reliability and Relevance Qualitative Characteristics can be useful but its usefulness shall be limited if it lacks understandability and comparability. We may explain this with the help of a diagram :



1.4 ACCOUNTING TERMS

Transaction

It is an event which involves exchange of some value between two or more entities. It can be purchase of stationery, receipt of money, payment to a supplier, incurring expenses, etc. It can be a cash transaction or a credit transaction.

Purchases

This term is used for goods to be dealt-in i.e. goods are purchased for resale or for producing the finished products which are meant for sale. Goods purchased may be Cash Purchases or Credit Purchases. Thus, Purchase of goods is the sum of cash purchases and credit purchases.

Sundry Creditors

Creditors are persons who have to be paid by an enterprise an amount for providing goods and services on credit.

Sales

Sales are total revenues from goods or services provided to customers. Sales may be in cash or in credit.

Sundry Debtors

Persons who have to pay for goods sold or services rendered or in respect of contractual obligations. It is also termed as debtor, trade debtor, and accounts receivable.

Revenue (Sales)

Sales revenue is the amount by selling products or providing services to customers.

Other items of revenue common to many businesses are: Commission, Interest, Dividends, Royalties, and Rent received, etc.

Expenses

Costs incurred by a business in the process of earning revenue are called expenses. In general, expenses are measured by the cost of assets consumed or services used during the accounting period. The common items of expenses are: Depreciation, Rent, Wages, Salaries, Interest, Cost of Heating, Light and water and Telephone, etc.

Income

The difference between revenue and expense is called income. For example, goods costing ₹ 25000 are sold for ₹ 35000, the cost of goods sold, i.e. ₹ 25000 is expense,

Notes

the sale of goods, i.e. ₹ 35000 is revenue and the difference. i.e. ₹10000 is income. In other words, we can state that

Income = Revenue - Expense

Gain

Usually this term is used for profit of an irregular nature, for example, capital gain.

Loss

It means something against which the firm receives no benefit. It is a fact that expenses lead to revenue but losses do not, such as theft.

Profit

It is the excess of revenue of a business over its costs. It may be gross profit and net profit. Gross profit is the difference between sales revenue or the proceeds of goods sold and/or services provided over its direct cost of the goods sold. Net profit is the profit made after allowing for all types of expenses. There may be a net loss if the expenses exceed the revenue.

Expenditure

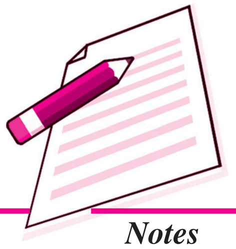
Spending money or incurring a liability for some benefit, service or property received is called expenditure. Payment of rent, salary, purchase of goods, purchase of machinery, etc. are some examples of expenditure. If the benefit of expenditure is exhausted within a year, it is treated as revenue expenditure. In case the benefit of expenditure lasts for more than one year, it is treated as an asset and also known as capital expenditure. Expenditure is usually the amount spent for the purchase of assets. It increases the profit earning capacity of the business. Expense, on the other hand, is an amount to earn revenue. Expenditure is considered as capital expenditure unless it is qualified with words like revenue expenditure on rent, salaries etc., while expense is always considered as a revenue expense because it is always incurred to earn revenue.

Drawings

It is the amount of money or the value of goods which the proprietor takes away from business for his/her household or private use.

Capital

It is the amount invested in an enterprise by its owners e.g. paid up share capital in a corporate enterprise. It also refers to the interest of owners in the assets of an enterprise. It is the claim against the assets of the business. Any amount contributed by the owner towards the business unit is a liability for the business enterprise. This liability is also termed as capital which may be brought in the form of cash or assets by the owner.



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Assets

These are tangible objects or intangible rights owned by the enterprise and carrying probable future benefits. Tangible items are those which can be touched and their physical presence can be noted/felt e.g. furniture, machine etc. Intangible rights are those rights which one possesses but cannot see e.g. patent rights, copyrights, goodwill etc. Assets are purchased for business use and are not for sale. They raise the profit earning capacity of the business enterprise.

Assets are broadly categorized as current assets and non-current assets/fixed assets. **Current assets** are those assets which are held for a short period generally one year's time. The balance of such items goes on fluctuating i.e. it keeps on changing throughout the year. The balance of cash in hand may change so many times in a day. Various current assets are cash in hand/at bank, debtors, bills receivable, stock, pre-paid expenses.

Non-current assets : Those assets are acquired for long term use in the business. Such assets raise the profit earning capacity of the business enterprise. Expenditure on such assets is non-recurring and of capital nature. Expenses incurred on acquiring these assets are added to the value of the assets.

Liability

It is the financial obligation of an enterprise other than owners' funds.

Liabilities : Liabilities mean the amount which the business owes to outsiders, that is, except the proprietors. In the words of **Finny and Miller,** *"Liabilities are debts, they are amounts owed to creditors."* Thus, the claims of those who are not owners are called **Liabilities.** This can be expressed as :

Liabilities = Assets – Capital

In business, transactions are recorded taking business to be an entity distinct from its owners. Thus, capital invested by the proprietors is a liability but an internal liability. On the other hand, *external liability* is a liability that is payable to outsiders, *i.e.,* other than the proprietors.

External liability arises because of credit transactions or loans raised. Examples of external liabilities are creditors, bank overdraft, bills payable, outstanding liabilities.

Liabilities can be classified into the following :

i. *Long-Term Liabilities :* These are those liabilities which are payable after a long-term, (generally more than a year). Examples of Long-Term Liabilities are long-term loans, debentures, etc.

Notes

ii. *Short-Term/Current Liabilities :* These are liabilities which are payable in the near future (generally within a year). Examples of Current Liabilities are creditors, bank overdrafts, bills payable, short-term loans, etc.

Account : Account is a summarised record of relevant transactions at one place relating to a particular head. It records not only the amount of transactions but also their effect and direction.

Stock or Inventory : Stock is the tangible property held by an enterprise for the purpose of sale in the ordinary course of business or for the purpose of using it in the production of goods meant for sale or services to be rendered. Stock may be *opening stock* or *closing stock*. In case of a manufacturing concern, Closing Stock comprises raw materials, Work-in-Progress (*i.e.,* semi-finished goods) and finished goods in hand on the closing date. Similarly, Opening Stock (beginning inventory) is the amount of stock at the beginning of the accounting period.

Goods : They refer to items forming part of the Stock-in-Trade of an enterprise, which are purchased or manufactured with a purpose of selling. In other words, they refer to the products in which an enterprise is dealing. For an enterprise dealing in home appliances such as T.V., fridge, A.C., etc., these are goods. Similarly, for a stationer, stationery is goods, whereas for others, it is an item of expense (not purchases). An enterprise may purchase assets for use in furtherance of business or stationery for use in the business, but they are not purchases of 'goods' but fixed asset and expense respectively.

Receivables : The term 'Receivables' includes the outstanding amount due from others. Sometimes, a debtor may accept a Bill of Exchange, which is payable after a certain period. Such a bill is known as **Bill Receivable**. Sometimes, a debtor promises to pay the specific amount in writing after a specified period. Such a promise is known as a **Promissory Note** and is recorded as *note receivable*. The term – *accounts receivable* includes trade debtors as well as bills receivable and promissory notes receivable. The term *receivable* includes all the amounts due from others.

Payables : The term 'Payables' include the amounts due to other. *Accounts Payable* includes trade creditors as well as bills payable and promissory notes payable. The term payable includes all the amounts due to others.

Bill Receivable : Bill Receivable means a Bill of Exchange accepted by a debtor the amount of which will be received on the specified date.

Bill Payable : Bill Payable means a Bill of Exchange, the amount of which will be payable on the specified date.

Event : Any transactions in an organisation can be called as an event. Transactions in an organisation have documentary evidence and will create a change in revenue, expense, assets, liabilities and capital.

Cost : It is the amount of expenditure incurred on or is attributed to a specified article; product or activity.

Voucher : It is proof of a business transaction. Cash Memo, Bill/Invoice, Credit/Debit notes etc. are examples of voucher.

Discount : Some customers are allowed reduction in the price of goods by the business. It is called a Discount.

Trade Discount : It is the reduction allowed by the seller to the buyer at the time of sale on the list price of goods. Trade discount is allowed on bulk purchases. Normally, trade discount is deducted from the list price and only the balance is accounted for. Therefore, trade discount will not be shown in the books of accounts.

Cash Discount : It is the deduction allowed by the creditor to the debtor on the amount due by the latter. This concession is given only to those who settle their accounts within a stipulated period. Therefore, cash discount encourage prompt settlement of accounts. For the debtor who pays the amount, it is an income. For creditor, cash discount is an expense.

INTEXT QUESTIONS 1.4

Fill in the blanks :

i. Stock is a ____________ asset.

ii. Liabilities = Assets - ____________

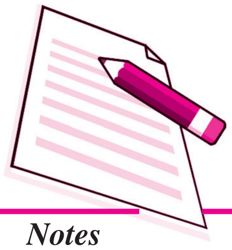
iii. Debentures are ____________ term liabilities.

iv. Creditors are ____________ term liabilities.

Role of an Accountant in Society

The accountant with his specialized knowledge, extensive training and experience is not merely responsible for preparing accounts, rather he/she is the best equipped person to provide other related services normally required by the management. This helps the management to discharge their duties more effectively thereby providing for efficient utilization of resources. The accountants' role in the society includes the following :

- To maintain the proper books of accounts which portray the true and fair view of the results of the business.
- To provide information and reports to management to enable them to discharge their duties more effectively.



Notes

- To act as auditor for attestation of accounts as per the requirement of law.
- To act as an internal auditor to assist and strengthen the hands of the management.
- To act as tax consultant to handle the tax matters of the business.
- To act as management consultant to provide services regarding financial planning of the business to their clients.

INTEXT QUESTIONS 1.5

I. Write against the following statements the terms for which these are made in reference to accounting information.

i. It is a common language used to communicate financial information.

ii. Managing Director, functional managers, shareholders etc using the accounting information.

iii. Ability of the firm to meet all its short term or current obligations as and when they fall due.

II. State in each case, whether the items are to be regarded as goods or assets.

i. Furniture purchased by Makhan Singh, a dealer in furniture.

ii. Automatic Machine purchased by a workshop for manufacturing products.

iii. Machine manufactured by a firm for sale to a mill.

iv. Furniture purchased by Malti, a stationery shop-owner.

III. Multiple Choice Questions :

i. Goods in hand at the end of a year is called ____________.

a) Purchases b) cost c) stock d) profit

ii. A Bill of Exchange is considered as _________ from the view point of creditors.

a) Bills receivable b) Bills payable

c) Discounting d) None of the above

iii. A Bill of Exchange is _______________ from the view point of debtors.

a) Bills Receivable b) Bills Payable

c) Endorsement d) None of the above

iv. ______________ are reductions allowed either on selling price or on the amount due.

a) Discount b) Cost

c) Bills d) All of the above

WHAT YOU HAVE LEARNT

- Accounting is the art of recording, classifying and summarizing in terms of money transactions and events of a financial nature and interpreting the results thereof. It is the process of collecting, recording, summarizing and communicating financial information. It is an information system which generates information for decision making by the interested parties.
- Recording of business transactions in a systematic manner in the books of accounts is called book keeping.
- Accounting consists of economic events which are identified, measured, recorded and communicated.
- Branches of accounting : Financial accounting, cost accounting and management accounting are some of the branches of accounting.
- Accounting in modern times is treated as an information system which has transaction, accounting process, decision useful financial information as the necessary ingredients.
- The accountant with his specialised knowledge extensive training and experience helps the management and plays an important role in the society.
- Important accounting terms are : Business entity, transactions, purchases, sales, debtors, creditors, etc.

TERMINAL EXERCISE

1. What is accounting? What are its objectives and limitations?
2. Distinguish between book-keeping and accounting.
3. Explain the different branches of accounting.
4. Explain the role of an accountant in the society.
5. Explain accounting as a system of information. Enlist the parties that are interested in the accounting information.

Notes

6. What is expense? Explain with example.
7. What is meant by liability? Explain with the help of examples.
8. State the meaning of the term 'Asset' with examples.

ANSWERS TO INTEXT QUESTIONS

1.1 I. i. Book keeping ii. Analysing
iii. Accounting iv. Investors, Creidtors etc.

II. i. B ii. B iii. A iv. A v. A

1.2 I. i. Cost accounting ii. Social accounting
iii. Management accounting

II. i. The effect of rise in price is not taken into consideration
ii. Estimates are sometimes inaccurate
iii. Profit can be manipulated by window dressing
iv. Non monetary transactions are completely omitted.

III. i. Systematic records are accepted as evidence in court.
ii. Systematic record keeping replaces memory.
iii. Accounting provides the financial information for decision making.

1.3 i. T ii. T iii. F

1.4 i. current ii. capital iii. long iv. short

1.5 I. i. Accounting ii. users iii. language of business

II. i. Goods ii. Assets iii. Goods iv. Assets

III. i. c ii. a iii. b iv. a

ACTIVITY

One day you have visited your friend Shiva who runs a grocery shop and casually talked about the accounts he maintains of his business unit. You were surprised to note that he did not maintain accounts. Enquire from other businessmen you know about their accounting records and about the uses and purposes of accounting. Explain them to your friend Shiva to motivate him to maintain accounts of his business unit.

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2

ACCOUNTING CONCEPTS

In the previous lesson, you have studied the meaning and nature of business transactions and objectives of financial accounting. In order to maintain uniformity and consistency in preparing and maintaining books of accounts, certain rules or principles have been evolved. These rules/principles are classified as concepts and conventions. These are foundations of preparing and maintaining accounting records. In this lesson we will learn about various accounting concepts, their meaning and significance.

OBJECTIVES

After studying this lesson, you will be able to

- explain the term accounting concept and
- explain the meaning and significance of various accounting concepts : Business Entity, Money Measurement, Going Concern, Accounting Period, Cost Concept, Duality Aspect concept, Realisation Concept, Accrual Concept and Matching Concept.

2.1 MEANING OF ACCOUNTING CONCEPT

Let us take an example. In India there is a basic rule to be followed by everyone that one should walk or drive on the left hand side of the road. It helps in the smooth flow of traffic. Similarly, there are certain rules that an accountant should follow while recording business transactions and preparing accounts. These may be termed as accounting concepts. Thus, it can be said that :

> Accounting concepts refer to the basic assumptions, rules and principles which work as the basis for recording of business transactions and preparing accounts.

The main objective is to maintain uniformity and consistency in accounting records. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus, they are universally accepted rules. Following are the various accounting concepts that have been discussed in the following sections :

- Business entity concept
- Money measurement concept
- Going concern concept
- Accounting period concept
- Accounting cost concept
- Duality aspect concept
- Realisation concept
- Accrual concept
- Matching concept

2.2 BUSINESS ENTITY CONCEPT

This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense. Thus, the accounting records are made in the books of accounts from the point of view of the business unit and not the person owning the business. This concept is the very basis of accounting.

Let us take an example. Suppose Mr. Sahoo started business investing ₹100000. He purchased goods for ₹40000, Furniture for ₹20000 and plant and machinery of ₹30000. ₹10000 remains in hand. These are the assets of the business and not of the owner. According to the business entity concept ₹100000 will be treated by business as capital i.e. a liability of business towards the owner of the business.

Now suppose, he takes away ₹5000 cash or goods worth ₹5000 for his domestic purposes. This withdrawal of cash/goods by the owner from the business is his private expense and not an expense of the business. It is termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct persons. Accordingly, any expense incurred by owner for himself or his family from business will be considered as expenses and it will be shown as drawings.

Significance

The following points highlight the significance of business entity concept :

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- This concept restraints accountants from recording of owner's private/personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view
- It is the very basis of accounting concepts, conventions and principles.

INTEXT QUESTIONS 2.1

Fill in the blanks with suitable word/words

i. The accounting concepts are basic ___________ of accounting.

ii. The main objective of accounting concepts is to maintain ___________ and ___________ in the accounting record.

iii. ___________ concept assumes that business enterprise and its owners are two separate independent entities.

iv. The goods drawn from business for owner's personal use are called ___________.

2.3 MONEY MEASUREMENT CONCEPT

This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees.

Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts. For example, sale of goods worth ₹200000, purchase of raw materials ₹100000, Rent Paid ₹10000 etc. are expressed in terms of money, and so these are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts. For example, sincerity, loyality, honesty of employees are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Another aspect of this concept is that the records of the transactions are to be kept not in the physical units but in the monetary unit. For example, at the end of the year 2013,

an organisation may have a factory on a piece of land measuring 10 acres, office building containing 50 rooms, 50 personal computers, 50 office chairs and tables, 100 kg of raw materials etc. These are expressed in different units. But for accounting purposes they are to be recorded in money terms i.e. in rupees. In this case, the cost of factory land may be say ₹12 crore, office building of ₹10 crore, computers ₹10 lakhs, office chairs and tables ₹2 lakhs, raw material ₹30 lakhs. Thus, the total assets of the organisation are valued at ₹22 crore and ₹42 lakhs. Therefore, the transactions which can be expressed in terms of money is recorded in the accounts books, that too in terms of money and not in terms of the quantity.

Significance

The following points highlight the significance of money measurement concept :

- This concept guides accountants about what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

INTEXT QUESTIONS 2.2

Put a tick mark (√) against the information that should be recorded in the books of accounts and cross mark (×) against the information that should not be recorded

i. Health of the managing director

ii. Purchase of factory building ₹10 crore

iii. Rent paid ₹100000

iv. Goods worth ₹ 10000 given as charity

v. Delay in supply of raw materials

2.4 GOING CONCERN CONCEPT

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance

sheet; For example, a company purchases a plant and machinery of ₹100000 and its life span is 10 years. According to this concept every year some amount will be shown as expenses and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it will not be proper to charge the amount from the revenues of the year in which the item is acquired. Only a part of the value is shown as expense in the year of purchase and the remaining balance is shown as an asset.

Significance

The following points highlight the significance of going concern concept :

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the fixed assets.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- A business is judged for its capacity to earn profits in future.

INTEXT QUESTIONS 2.3

Fill in the blanks by selecting correct words given in the bracket/brackets:

i. Going concern concept states that every business firm will continue to carry on its activities ___________ (for a definite time period, for an indefinite time period)

ii. Fixed assets are shown in the books at their _________ (cost price, market price)

iii. The concept that a business enterprise will not be closed down in the near future is known as ___________ (going concern concept, money measurement concept)

iv. On the basis of going concern concept, a business prepares its ___________ (financial statements, bank statement, cash statement)

v. ___________ concept states that business will not be dissolved in near future. (Going concern, Business entity)

Notes

2.5 ACCOUNTING PERIOD CONCEPT

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.

Further, this concept assumes that, indefinite life of business is divided into parts. These parts are known as Accounting Period. It may be of one year, six months, three months, one month, etc. But usually one year is taken as one accounting period which may be a calender year or a financial year.

> Year that begins from 1st of January and ends on 31st of December, is known as Calendar Year. The year that begins from 1st of April and ends on 31st of March of the following year, is known as financial year.

As per accounting period concept, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent, salaries etc. paid for the period are accounted for against that period only.

Significance

- It helps in predicting the future prospects of the business.
- It helps in calculating tax on business income calculated for a particular time period.
- It also helps banks, financial institutions, creditors, etc to assess and analyse the performance of business for a particular period.
- It also helps the business firms to distribute their income at regular intervals as dividends.

INTEXT QUESTIONS 2.4

Fill in the blanks with suitable word/words :

i. Recording of transactions in the books of accounts with a definite period is called .... concept.

ii. The commonly accepted accounting period in India is ....

iii. According to accounting period concept, revenue and expenses are related to a .... period.

iv. If accounting year begins from 1st of January, and ends on 31st of December, it is known as ....

v. If accounting year begins from 1st of April and ends on 31st of March of the following year, then accounting year is known as ....

Notes

2.6 ACCOUNTING COST CONCEPT

Accounting cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them. For example, a machine was purchased by XYZ Limited for ₹500000, for manufacturing shoes. An amount of ₹1,000 were spent on transporting the machine to the factory site. In addition, ₹2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e. ₹503000. This cost is also known as historical cost. Suppose the market price of the same is now ₹ 90000 it will not be shown at this value. Further, it may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The cost concept is also known as historical cost concept. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price.

Significance

- This concept requires asset to be shown at the price at which it has been acquired, which can be verified from the supporting documents.
- It helps in calculating depreciation on fixed assets.
- The effect of cost concept is that if the business entity does not pay anything for an asset, this item will not be shown in the books of accounts.

INTEXT QUESTIONS 2.5

Fill in the blanks with suitable word/words

i. The cost concept states that all fixed assets are recorded in the books of accounts at their ____________ price.

ii. The main objective to adopt historical cost in recording the fixed assets is that the cost of the assets will be easily verifiable from the ____________ documents.

iii. The cost concept does not show the .... of the business.

iv. The cost concept is otherwise known as .... concept.

Notes

2.7 DUAL ASPECT CONCEPT

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded.

Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :

Assets = Liabilities + Capital

The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. This claim is also termed as capital or owners equity and that of outsiders, as liabilities or creditors' equity.

The knowledge of dual aspect helps in identifying the two aspects of a transaction which helps in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

Let us analyse some more business transactions in terms of their dual aspect :

1. Capital brought in by the owner of the business

   The two aspects in this transaction are :

   (i) Receipt of cash

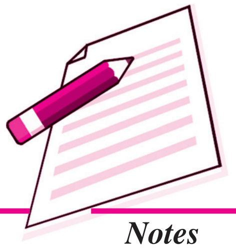
   (ii) Increase in Capital (owners equity)

2. Purchase of machinery by cheque

   The two aspects in the transaction are

   (i) Reduction in Bank Balance

   (ii) Owning of Machinery



Notes

3. Goods sold for cash

   The two aspects are

   (i) Receipt of cash

   (ii) Delivery of goods to the customer

4. Rent paid in cash to the landlord

   The two aspects are

   (i) Payment of cash

   (ii) Rent (Expenses incurred).

Once the two aspects of a transaction are known, it becomes easy to apply the rules of accounting and maintain the records in the books of accounts properly.

The interpretation of the Dual aspect concept is that every transaction has an equal effect on assets and liabilities in such a way that total assets are always equal to total liabilities of the business.

Significance

- This concept helps accountant in detecting error.
- It encourages the accountant to post each entry in opposite sides of two affected accounts.

INTEXT QUESTIONS 2.6

Write the two aspects (effects) of the following transactions.

S.No.	Transaction	Ist aspect	IInd aspect
(i)	Owner brings cash in business		
(ii)	Goods purchased for cash		
(iii)	Goods sold for cash		
(iv)	Furniture purchased for cash		
(v)	Received cash from Sharma		
(vi)	Purchased machine from Rama on credit		
(vii)	Paid to Ram		
(viii)	Salaries Paid		
(ix)	Rent Paid		
(x)	Rent Received		

Notes

2.8 REALISATION CONCEPT

This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not.

In other words, it can be said that :

> Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both have been created.

Let us study the following examples :

i. N.P. Jeweller received an order to supply gold ornaments worth ₹5,00,000. They supplied ornaments worth ₹2,00,000 up to the year ending 31st December 2013 and rest of the ornaments were supplied in January 2014.

ii. Bansal sold goods for ₹1,00,000 for cash in 2013 and the goods have been delivered during the same year.

iii. Akshay sold goods on credit for ₹50,000 during the year ending 31st December 2013. The goods have been delivered in 2013 but the payment was received in March 2014.

Now, let us analyse the above examples to ascertain the correct amount of revenue realised for the year ending 31st December 2013.

i. The revenue for the year 2013 for N.P. Jeweller is ₹200000. Mere getting an order is not considered as revenue until the goods have been delivered.

ii. The revenue for Bansal for year 2013 is ₹1,00,000 as the goods have been delivered in the year 2013. Cash has also been received in the same year.

iii. Akshay's revenue for the year 2013 is ₹50,000, because the goods have been delivered to the customer in the year 2013. Revenue became due in the year 2013 itself. In the above examples, revenue is realised when the goods are delivered to the customers.

> The concept of realisation states that revenue is realized at the time when goods or services are actually delivered.

In short, the realisation occurs when the goods and services have been sold either for cash or on credit. It also refers to inflow of assets in the form of receivables.

Significance

- It helps in making the accounting information more objective.
- It provides that the transactions should be recorded only when goods are delivered to the buyer.

Notes

INTEXT QUESTIONS 2.7

Ascertain the amount of current revenue realized for the year ending 31st December 2006

i. An order, to supply goods for ₹20,00,000 is received in the year 2006. The goods have been supplied only for ₹10,00,000 in 2006.

ii. What will be the revenue (i) if the payment of ₹6,00,000 is received in cash in 2006 and the balance payment of ₹4,00,000 received in 2007.

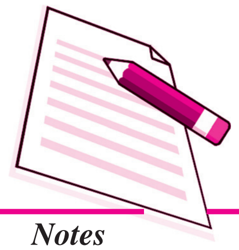
iii. What will be the revenue if the goods have been sold on credit and the payment of ₹1500000 is received in the year 2007, while all the goods of ₹20,00,000 are supplied in the year 2006.

iv. What will be the revenue if an advance payment of ₹100,000 is received in the year 2006 and the balance received in the year 2007.

2.9 ACCRUAL CONCEPT

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses.

The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of the fact when the cash is received. For example, a firm sells goods for ₹55000 on 25th March 2014 and the payment is not received until 10th April 2014, the amount is due and payable to the firm on the date of sale i.e. 25th March 2014. It must be included in the revenue for the year ending 31st March 2014. Similarly, expenses are recognised at the time services provided, irrespective of the fact when actual payment for these services are made. For example, if the firm received goods costing ₹20000 on 29th March 2014 but the payment is made on 2nd April 2014 the accrual concept requires that expenses must be recorded for the year ending 31st March 2014 although no payment has been made until 31st March 2014 though the service has been received and the person to whom the payment should have been made is shown as creditor.



Notes

In brief, accrual concept requires that revenue is recognised when realised and expenses are recognised when they become due and payable without regard to the time of cash receipt or cash payment.

Significance

- It helps in knowing actual expenses and actual income during a particular time period.
- It helps in calculating the net profit of the business.

INTEXT QUESTIONS 2.8

Fill in the blanks with suitable word/words :

i. Accrual concept relates to the determination of ....

ii. Goods of ₹50000 are sold on 25th March 2014 but payment is received on 10th April 2014. It will be a revenue for the year ending ....

iii. Accrual concept requires revenue is recognised when .... and expenses are recognised when they become ....

2.10 MATCHING CONCEPT

The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept.

Let us study the following transactions of a business during the month of December, 2006

(i) Sale : cash ₹2000 and credit ₹1000

(ii) Salaries Paid ₹350

(iii) Commission Paid ₹150

(iv) Interest Received ₹50

(v) Rent received ₹140, out of which ₹40 received for the year 2007

(vi) Carriage paid ₹20

(vii) Postage ₹30

(viii) Rent paid ₹200, out of which ₹50 belong to the year 2005

(ix) Goods purchased in the year for cash ₹1500 and on credit ₹500

(x) Depreciation on machine ₹200

Notes

Let us record the above transactions under the heading of Expenses and Revenue.

Expenses		*Amount* ₹	*Revenue*		*Amount* ₹
1. Salaries		350	1. Sales		
2. Commission		150	Cash	2000	
3. Carriage		20	Credit	1000	3000
4. Postage		30	2. Interest received		50
5. Rent paid	200		3. Rent received	140	
Less for 2005	-50	150	Less for 2007	(40)	100
6. Goods purchased					
Cash	1500				
Credit	500	2000			
7. Depreciation on machine		200			
Total		2900	Total		3150

In the above example expenses have been matched with revenue i.e (Revenue ₹3150- Expenses ₹2900) This comparison has resulted in profit of ₹250. If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept.

Therefore, the matching concept implies that all revenues earned during an accounting year, whether received/not received during that year and all cost incurred, whether paid/not paid during the year should be taken into account while ascertaining profit or loss for that year.

Significance

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.
- It is very helpful for the investors/shareholders to know the exact amount of profit or loss of the business.

INTEXT QUESTIONS 2.9

Fill in the blanks with suitable word/words :

i. Expenses are matched with ____________ generated during a period.

ii. Goods sold for cash is an example of ____________.

iii. Salaries paid is an example of ____________.

iv. Income is the excess of ____________ over ____________.

v. ____________ concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period

vi. ___________ concept states how the expenses should be compared with revenues for ascertaining exact profit or loss for a particular period

Notes

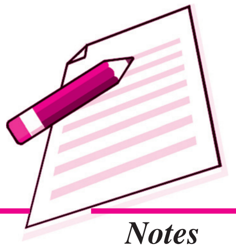
WHAT YOU HAVE LEARNT

- Accounting concepts refer to the basic assumptions which serve the basis of recording actual business transactions.
- The important accounting concepts are business entity, money measurement, going concern, accounting period, cost concept, duality aspect concept, realisation concept, accrual concept, and matching concept.
- Business entity concept assumes that for accounting purposes, the business enterprise and its owner(s) are two separate entities.
- Money measurement concept assumes that all business transactions must be recorded in the books of accounts in terms of money.
- Going concern concept states that a business firm will continue to carry on activities for an indefinite period of time.
- Accounting period concept states that all the business transactions are recorded in the books of accounts on the assumption that profits of transactions is to be ascertained for a specified time period.
- Accounting cost concept states that all assets are recorded in the books of accounts at their cost price.
- Dual aspect concept states that every transaction has a dual effect.
- Realisation concept states that revenue from any business transaction should be included in the accounting records only when it is realised
- Matching concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period

TERMINAL EXERCISE

1. Explain meaning and significance of going concern concept.
2. What do you mean by business entity concept?
3. State meaning and significance of money measurement concept.
4. Write short notes on the following

   (a) Cost concept (b) Accrual concept



Notes

(c) Matching concept (d) Accounting period concept

5. What do you mean by accounting concept? Explain any four accounting concepts.

ANSWERS TO INTEXT QUESTIONS

2.1 (i) rules (ii) uniformity and consistency
(iii) Business entity concept (iv) drawings

2.2 (i) × (ii) √ (iii) √ (iv) √ (v) ×

2.3 (i) for an indefinite time period (ii) cost price
(iii) going concern concept (iv) financial statements (v) Going concern

2.4 (i) accounting period (ii) one year (iii) particular
(iv) calender year (v) financial year

2.5 (i) purchase (ii) supporting (iii) true net worth (iv) historical cost

2.6 (i) Owner's capital, cash (ii) Goods received, cash
(iii) Cash received, goods sold (iv) Furniture, cash
(v) Cash, Sharma (vi) Machine, Rama (vii) Ram, cash
(viii) Salaries, cash (ix) Rent, cash (x) Cash, rent

2.7 (i) ₹10,00,000 (ii) ₹10,00000 (iii) ₹20,00,000 (iv) ₹1,00,000

2.8 (i) income (ii) 31st March, 2006 (iii) realised, due

2.9 (i) revenue (ii) revenue (iii) expense (iv) revenue, expenses
(v) matching (vi) matching

ACTIVITY

In our country business concerns are not following the same accounting period every year. Enquire from various sources and list various such periods prevailing in our country. One for example is given

1. Year ending 31st March (financial year)
2. ______________________________
3. ______________________________

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3

ACCOUNTING CONVENTIONS AND STANDARDS

In the previous lesson, you have studied the accounting concepts like business entity, money measurement, going concern, accounting period, cost, duality, realisation, accrual and matching. These concepts or assumptions or principles are working rules for all accounting activities.

You may visit some business units doing a particular kind of business. Enquire them and find out how unsold goods are being valued. You will find that they follow the same method of valuation of unsold stock of goods. If you ask them, why do they value the unsold goods at cost or market price, whichever is lower, even though the market price is higher than the cost price, the businessman may answer that it is the convention, tradition or practice or custom of the business, that business is following year after year. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts. Apart from these, the Institute of Chartered Accountants of India (ICAI), which is the main regulatory body for standardisation of accounting policies in the country has issued a number of accounting standards from time to time to bring consistency in the accounting practices. We shall study about accounting conventions and standards in detail in this lesson.

OBJECTIVES

After studying this lesson, you will be able to :

- explain the meaning of accounting convention;
- explain the meaning and significance of accounting consventions like consistency, full disclosure, materiality and conservatism;
- state the meaning of the term Generally Accepted Accounting Principles (GAAP);

- explain the concept of accounting standards and enumerate the various accounting standards issued by the Institute of Chartered Accountants of India.

3.1 MEANING OF ACCOUNTING CONVENTIONS

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. They are followed like customs, traditions, etc. in a society. Accounting conventions are evolved through the regular and consistent practice over the years to facilitate uniform recording in the books of accounts. Accounting Conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years. The most important conventions which have been used for a long period are :

- Convention of consistency.
- Convention of full disclosure.
- Convention of materiality.
- Convention of conservatism.

3.2 CONVENTION OF CONSISTENCY

The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is a comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable.

Generally a businessman follows the undermentioned general practices or methods year after year.

While charging depreciation on fixed assets or valuing unsold stock, once a particular method is used it should be followed year after year so that the financial statements can be analysed and compared provided that the depreciation on fixed assets is charged or unsold stock is valued by using particular method year after year. This can be further clarified as : in case of charging depreciation on fixed assets accountant can decide to adopt any one of the methods of depreciation such as diminishing value method or straight line method.

Similarly, in case of valuation of closing stock it can be valued at actual cost price or market price or whichever is less. However precious metals like gold, diamond, minerals are generally valued at market price only.

Notes

Types of consistency

There are three types of consistency namely :

i. **Vertical consistency (Same organisation) :** It is to be found within the group of inter-related financial statements of an organisation on the same date. It occurs when fixed assets have been shown at cost price and in the interrelated income statement depreciation has also been charged on the historical cost of the assets.

ii. **Horizontal consistency (Time basis) :** This consistency is to be found between financial statements of one entity from period to period. Thus, it helps in comparing performance of the business between two years i.e. current year with past year.

iii. **Dimensional consistency (Two organisations in the same trade) :** This consistency is to be found in the statements of two different business entities of the same period. This type of consistency assists in making comparison of the performance of one business entity with the other business entity in the same trade and on the same date.

Therefore, as per this convention the same accounting methods should be adopted every year in preparing financial statements. But it does not mean that a particular method of accounting once adopted can never be changed. Whenever a change in method is necessary, it should be disclosed by way of footnotes in the financial statements of that year.

Significance

- It facilitates comparative analysis of the financial statements.
- It ensures uniformity in charging depreciation on fixed assets and valuation of closing stock.

INTEXT QUESTIONS 3.1

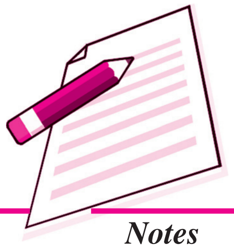
Fill in the blanks with suitable word/words

i. Convention of consistency means that same accounting principles should be used for preparing financial statements ....

ii. Unsold goods are valued at cost price or .... whichever is ....

iii. Precious metals, like gold, mineral and others are generally valued at...........

iv. As per the convention of .... year after year same methods are followed.



Notes

3.3 CONVENTION OF FULL DISCLOSURE

Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. **Adequate** means sufficient set of information to be disclosed. **Fair** indicates an equitable treatment of users. **Full** refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information. Let us relate it to the business. The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholders would like to know profitability of the firm while the creditors would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statements disclose all relevant information in full, fair and adequate manner.

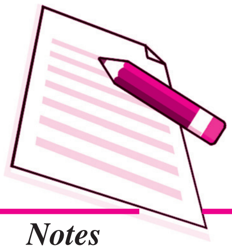
Let us take an example. As per accounts, net sales are ₹1,50,000, it is important for the interested parties to know the amount of gross sales which may be ₹2,00,000 and the sales return ₹50,000. The disclosure of 25% sales returns may help them to find out the actual sales position. Therefore, whatever details are available, that must be honestly provided. Additional information should also be given in the financial statements. For example, in a balance sheet the basis of valuation of assets, such as investments, inventories, land and building etc. should be clearly stated. Similarly, any change in the method of depreciation or in making provision for bad debts or creating any reserve must also be shown clearly in the Balance Sheet. Therefore, in order to achieve the purpose of accounting, all the transactions of a business and any change in accounting policies, methods and procedures are fully recorded and presented in accounting.

To ensure proper disclosure of material accounting information, the Companies Act 1956, under schedule VI has provided a format for the preparation of Profit and Loss account and Balance Sheet of a company. It is necessary for every company to follow this format. The regulatory bodies like Securities and Exchange Board of India (SEBI) has also made compulsory for complete disclosures by registered companies.

Significance

- It helps in meaningful comparison of financial statements of the different business units.
- This can also help in the comparison of financial statements of different years of the same business unit.
- This convention is of great help to investor and shareholder for making investment decisions.
- The convention of full disclosure presents reliable information.

INTEXT QUESTIONS 3.2



Notes

Fill in the blanks with appropriate word/words :

i. The shareholders would like to know about the ___________ of the business.

ii. The convention of full disclosure requires that there should be full, ___________ and ___________ disclosure of accounting information.

iii. The creditors are interested to know the ___________ of the business.

iv. All relevant material facts should be ___________ in the financial statements.

v. The full disclosure convention presents ___________ information.

3.4 CONVENTION OF MATERIALITY

The convention of materiality states that, to make financial statements meaningful, only material facts i.e. important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Material fact means the information of which will influence the decision of its user.

For example, a businessman is dealing in electronic goods. He purchases T.V., Refrigerator, Washing Machine, Computer etc. for his business. In buying these items he uses larger part of his capital. These items are significant items; thus, these should be recorded in the books of accounts in detail. At the same time to maintain day to day office work he purchases pen, pencil, match box, scented stick, etc. For this he will use very small amount of his capital. But to maintain the details of every pen, pencil, match box or other small items is not considered of much significance. These items are insignificant items and hence they should be recorded separately. Thus, the items that are significantly important in recording the details are termed as material facts or significant items. The items that are of less significance are immaterial facts or insignificant items.

Thus according to this convention, important and significant items should be recorded in their respective heads and all immaterial or insignificant transactions should be clubbed under a different accounting head.

Significance

- It helps in minimising the errors of calculation.
- It helps in making financial statements more meaningful.
- It saves time and resources.

INTEXT QUESTIONS 3.3

Fill in the blanks with suitable word/words :

i. ___________ convention states that to make financial statements more meaningful, only significant and important items should be supplied to the users.

ii. Convention of materiality states that significant items should be disclosed under ___________.

iii. ___________ convention keeps accounts manager to focus on important /significant items.

iv. ___________ means the information which will influence the decision of its users.

3.5 CONVENTION OF CONSERVATISM

This convention is based on the principle that **"Anticipate no profit, but provide for all possible losses"**. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.

Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future, provision should be made in the books of accounts for the same. For example, valuing closing stock at cost or market price whichever is lower, creating provision for doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent, etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

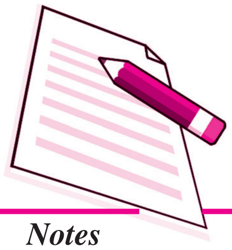
Significance

- It helps in ascertaining actual profit.
- It is useful in the situation of uncertainties and doubts.
- It helps in maintaining the capital of the enterprise.

INTEXT QUESTIONS 3.4

Give your decision in the following situations :

i. A business has unsold stock at the end of year. The cost price is ₹2,00,000 and the market price is ₹2,50,000. At which price the unsold stock be recorded ?



Notes

ii. What will be your decision if the cost price in the above case is ₹2,10,000 ?

iii. A businessman anticipates that it may not be possible to collect ₹50,000 from one of his debtors. will he record this transaction in the books of accounts and at what value?

3.6 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) AND ACCOUNTING STANDARDS

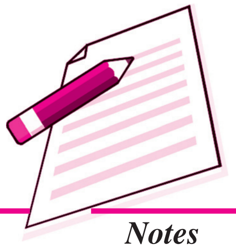
In order to maintain uniformity and consistency in accounting records throughout the world, certain rules and principles have been developed which are generally accepted by the accounting profession. These rules/principles are called by different names such as principles, concepts, conventions, postulates, assumptions. These rules/principles are judged on their general acceptability rather than universal acceptability. Hence, they are popularly called Generally Accepted Accounting Principles (GAAP). The term "generally accepted" means that these principles must have support, that generally comes from the professional accounting bodies. Thus, Generally Accepted Accounting Principles (GAAP) refer to the rules or guidelines adopted for recording and reporting of business transactions of financial statements. These principles have evolved over a long period of time on the basis of past experiences, usages or customs, etc. These principles are also referred as concepts and conventions, which have already been discussed.

Accounting standards : Concept and Objectives

The term standard denotes a discipline, which provides both guidelines and yardsticks for evaluation. As guidelines, accounting standards provide uniform practices and common techniques of accounting. As a general rule, accounting standards are applicable to all corporate enterprises. They are made operative from a date specified in the standards. The Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) in April, 1977 for developing accounting standards. However, the International Accounting Standards Committee (IASC) was set up in 1973, with its headquarter in London (U.K.).

The Accounting Standards Board is entrusted with the responsibility of formulating standards on significant accounting matters keeping in view the international developments, and legal requirements in India.

The main function of the ASB is to identify areas in which uniformity in standards is required and to develop draft standards after discussions with representatives of the Government, public sector undertakings, industries and other agencies.



Notes

In the initial years, the standards are of recommendatory in nature. Once an awareness is created about the benefits and relevance of accounting standards, steps are taken to make the accounting standards mandatory for all companies. In case of non compliance, the companies are required to disclose the reasons for deviations and its financial effects:

Till date, the IASC has brought out 40 accounting standards. However, the ICAI has so far issued 29 accounting standards. These are :

AS-1 Disclosure of accounting policies (January 1979). This standard deals with the disclosure of significant accounting policies in the financial statements.

AS-2 Valuation of Inventories (June 1981). This standard deals with the principles of valuing inventories for the financial statements.

AS-3 **(Revised)** Cash flow statement (June 1981, Revised in March 1997). This standard deals with the financial statement which summarises for a given period the sources and applications of an enterprise.

AS-4 Contingencies and events occurring after the Balance Sheet date (November 1982, Revised in April, 1995) This standard deals with the treatment of contingencies and events occurring after the balance sheet date.

AS-5 Net profit or loss for the period, prior period (period before the date of balance sheet) items and changes in accounting policies (November 1982, Revised in February 1997). This standard deals with the treatment in financial statement of prior period and extraordinary items and changes in accounting policies.

AS-6 Depreciation Accounting (November 1982). This standard applies to all depreciable assets. But this standard does not apply to assets in the category of forests, plantations and similar natural resources and wasting assets.

AS-7 Accounting for construction contracts (December 1983, revised in April 2003). This standard deals with accounting for construction contracts in the financial statements of contractors.

AS-8 Accounting for Research and Development (January 1985). This standard deals with the treatment of costs of research and development in financial statements.

AS-9 Revenue Recognition (November 1985). This standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise.

AS-10 Accounting for fixed assets (November 1991). This standard deals with recognition of fixed assets grouped into various categories, such as land, building, plant and machinery, vehicles, furniture and gifts, goodwill, patents, trading and designs.

AS-11 Accounting for the effects of change in foreign exchange Rates. (August 1991 and Revised in 1993). This standard deals with the issues relating to accounting for effect of change in foreign exchange rates.

AS-12 Accounting for Government grants (April 1994). This standard deals with the accounting for government grants.

AS-13 Accounting for investments (September 1994). This standard deals with accounting aspect concerning investments in the financial statements. These include classification, determination of cost for initial recognition, disposal and re-classification of investment.

AS-14 Accounting for amalgamation (October 1994). This standard deals with accounting treatment of any resultant goodwill or reserves in amalgamation of companies.

AS-15 Accounting for retirement Benefits in the financial statements of employers (January 1995). This standard deals with accounting for retirement benefits in the financial statements of employers.

AS-16 Borrowing Costs (April 2000). This standard deals with the uses involved relating to capitalization of interest on borrowings for purchase of fixed assets.

AS-17 Segment reporting (October 2000). This standard applies to companies which have an annual turnover of ₹50 crores or more. These companies have to present segment wise financial statements and consolidated financial statements.

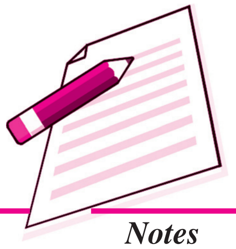
AS-18 Related party disclosures (October 2000 revised 1st July 2003). This standard requires certain disclosure which must be made for transactions between the enterprise and related parties.

AS-19 Leases (January 2001). This standard deals with the accounting treatment of transactions related to lease agreements.

AS-20 Earning per share (April 2001). This standard deals with the presentation and computation of earning per share (EPS).

AS-21 Consolidated financial statements (April 2001). This standard deals with the preparation of consolidated financial statements with an intention to provide information about the activities of a group.

AS-22 Accounting for taxes on Income (April 2001). This standard deals with determination of the account of tax expenses for the related revenue.



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AS-23 Accounting for investments in Associates in consolidated financial statements (July 2001). This standard deals with the principles and procedures to be followed for recognising, in the consolidated financial statement.

AS-24 Discontinued operations (February 2002). This standard deals with the principles of discontinuing operations of an enterprise with the activities which are continuing.

AS-25 Interim financial reporting (February 2002). This standard deals with the minimum content of interim financial report.

AS-26 Intangible Assets (February 2002). This standard prescribed the accounting treatment for intangible assets which are not covered by any other specific accounting standard.

AS-27 Financial reporting of interest for joint venture (February 2002). This standard sets principles and procedures for accounting for interest in joint venture.

AS-28 Impairment of Assets (2004). This standard prescribed procedures to ensure that an asset is carried at no more than its carrying amount and procedures as to when to recognise an asset as impaired.

AS-29 Provision for contingent labilities and contingent assets (2004). This standard deals with measurement and recognition criteria in three areas, namely provisions, contingent liabilities and contingent assets.

All the above standards issued by the Accounting Standards Board are recommended for use by companies listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

INTEXT QUESTIONS 3.5

Fill in the blank with appropriate words

i. AS1 deals with ....

ii. AS29 deals with ....

iii. AS26 deals with ....

iv. AS20 deals with ....

v. AS21 deals with ....

vi. AS22 deals with ....

vii. GAAP stands for ....

viii. Accounting standard Board (ASB) was established ....

ix. International Accounting Standard Committee was established ....

x. AS2 deals with ....

Notes

WHAT YOU HAVE LEARNT

- Accounting conventions are common practices which are followed in recording and presenting accounting information of business.
- Convention of consistency states that the same accounting methods should be adopted every year in preparing financial statements.
- Convention of disclosure states that all material and relevant facts relating to financial statements should be fully disclosed.
- Convention of materiality states that, to make financial statements more meaningful only significant information should be shown in the financial statements.
- Convention of conservatism states that, profit should not be recorded until it is realised. But if business anticipates any loss in near future provision should be made in the books of account.
- Generally accepted accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financial statements.

TERMINAL EXERCISE

1. Explain the convention of consistency with example.
2. Explain the accounting convention of conservatism with example.
3. What do you mean by accounting standards? Enumerate the accounting standard issued by the ASB from time to time.
4. Explains the convention of materiality.
5. Explain the accounting convention of full disclosure with example.

ANSWERS TO INTEXT QUESTIONS

3.1 (i) year after year (ii) market price, lower
(iii) market price (iv) consistency

3.2 (i) profitability (ii) fair, adequate (iii) solvency
(iv) disclosed (v) reliable

3.3 (i) Materiality (ii) separate head
(iii) Materiality (iv) Material fact

3.4 (i) cost price i.e. ₹2,00,000 (ii) Cost price i.e.₹21,00,000
(iii) Yes, as a bad debt ₹50,000

3.5 (i) Disclosure of accounting policies

(ii) Provisions, contingent liabilities and contingent assets

(iii) Intangible assets (iv) Earning per share

(v) Consolidated financial statements

(vi) Accounting for taxes on income

(vii) Generally Accepted Accounting principle

(viii) April, 1977 (ix) 1973 (x) Inventory valuation

ACTIVITY

Visit a number of business units and enquire from the accountants how do they deal with the following while preparing the accounts :

1. Valuation of the stock at the end of the accounting period.
2. At what intervals do they close their account books?
3. What method of depreciation did they use in the last three or four years?
4. Have they ever suffered losses or earned profits because of the lethargic attitude or loyality towards the organisation?

Complete the answer and draw the conclusion whether they are following some accounting concepts or not. If yes, name the accounting conventions/accounting concepts.

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4

ACCOUNTING FOR BUSINESS TRANSACTIONS

You visit the shop of a person known to you and observe the activities he/she is doing. He/she is selling goods for cash and on credit, collecting payments, making payments to suppliers, instructing the worker to deliver the goods in time, making payments for telephone, carriage, etc. These are all business activities, but cash is not involved in all of them at the time of making transactions. Activities which are in cash terms are called business transactions. You will also find that for every transaction, he/she makes use of a document like bills, cash memos, receipts, etc. These are termed as vouchers. In this lesson, you will learn about business transactions, accounting vouchers, accounting equation and the basic mechanism of accounting.

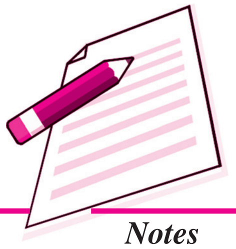
OBJECTIVES

After studying this lesson, you will be able to

- explain the meaning of source documents and accounting vouchers;
- explain the preparation of accounting vouchers;
- explain the meaning of accounting equation;
- explain the effect of business transactions on the accounting equation;
- explain the rules of accounting;
- explain the bases of accounting and
- explain the double entry mechanism.

4.1 SOURCE DOCUMENTS AND ACCOUNTING VOUCHERS

Accounting process begins with the origin of business transactions and it is followed by analysis of such transactions. A business transaction is a transaction, which involves exchange of values between two parties. Every transaction involves Give and Take



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aspect. The debit represents Take aspect and credit represents the Give aspect in a transaction. For example, when a computer is purchased for office use for cash, then the delivery of computer represents Take aspect and payment of cash represents Give aspect. Thus , business transactions are exchange of goods or services between two parties and effects of these transactions are recorded in two accounts.

Source Documents and vouchers

All business transactions are based on documentary evidence. A Cash memo showing cash sale, an invoice showing sale of goods on credit, the receipt made out by the payee against cash payment, are all examples of source documents. A document which provides evidence of the transactions is called the Source Document or a voucher. It is the primary evidence in support of a business transaction. A source document is the first record prepared for a business transaction and is the basis for entries in the books of accounts. There are certain items, which have no documentary proof, such as petty expenses. In such case necessary voucher is prepared showing the necessary details. All such documents are kept in a separate file in chronological order and are serially numbered. All recording in books of accounts is done on the basis of accounting vouchers. A Voucher is documentary evidence in support of a transaction. It is a document to record the accounting transaction. A transaction with one debit and one credit is a simple transaction and voucher prepared for such transaction is known as transaction voucher. The format of transaction voucher is as follows:

Transaction Voucher

Firm Name

Voucher No.
Date:
Debit account:
Credit account:
Amount (₹) :
Narration :
Authorised By : Prepared By:

Specimen of transaction voucher

Preparation of Accounting Vouchers

Accounting vouchers are the written documents containing the analysis of business transactions for accounting and recording purpose. These are prepared by the accountant and countersigned by authorised person. Features of Accounting vouchers are as :

- It is a written document.
- It is prepared on the basis of evidence of the transaction.

Notes

- It contains an analysis of a transaction i.e. which account has to be debited and which has to be credited.
- It is prepared by an accountant and countersigned by the authorised signatory.

Accounting voucher may be classified as Cash voucher i.e., debit voucher, credit voucher, and non-cash voucher i.e., transfer voucher.

Types of Accounting Voucher

- Cash Voucher
  - Debit voucher — [For Cash Payments]
  - Credit voucher — [For Cash Receipts]
- Non-Cash Voucher
  - (Transfer voucher) — [For Non-cash Transaction]

Debit Vouchers

These vouchers are prepared for recording of transactions involving cash payments only. Cash payments in the business are made on account of :

- Expenses
- Purchases of Goods
- Purchases of Assets
- Payment to creditors
- Repayment of loans
- Drawings and advances etc.

In all cash payments, one aspect is cash and the other is either the party to whom the payment is made, or an expense or an item of property for which the payment is made. A format of debit voucher is as follows:

Firm's Name

Debit Voucher

Voucher No. : Date:

Debit Account:

Amount:

Credit Account			
S.No.	Account Name	Amount (₹)	Narration (i.e. Explanation)
Authorised By:		Prepared By:	

Specimen of Debit voucher

Illustration 1

On September 21, 2014 M/s Mohit Chemicals paid ₹40,000 in Cash and balance amount of ₹1,60,000 by Banker's Cheque to HT Chemicals Ltd., Prepare Debit Voucher.

Solution:

Mohit Chemicals

Debit Voucher

Voucher No.: 22 Date: 21.9.2014

Debit Account: HT Chemicals Ltd

Amount : ₹ 200000.

Credit Accounts

S.No.	Account Name	Amount (₹)	Narration (i.e. Explanation)
1. 2.	Cash Bank	40,000 1,60,000	Paid Part payment in cash and balance by bank draft.
Authorised By:		Prepared By:	

Credit Vouchers

These vouchers are prepared for recording of transactions involving cash-receipts only. Cash receipts in the business are accepted on account of:

- Cash sales of goods
- cash sales of assets

Notes

- revenue income like interest, rent, etc. received in cash
- Cash receipts from debtors.
- Loan taken
- Cash withdrawn from bank
- receipts of advances, etc.

In all cash receipts, one aspect is cash and the other is either person or party from whom cash is received or revenue on account of which cash is received or the property on sale of which cash is received. A format of credit voucher is as follows:

Credit Voucher

Firm Name

Voucher No. : Date:

Debit Account:

Amount:

Credit Account

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*

Authorised By: Prepared By:

Fig. 4.3 Specimen of Credit voucher

Illustration 2

₹25000 Office furniture is purchased from Modern Furniture on July 4, 2014 and ₹15000 are paid by cash immediately and ₹10000 is still payable. Prepare Credit Voucher.

Solution:

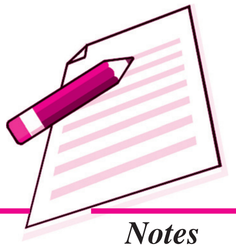
Credit Voucher

Modern Furniture

Voucher No. : 125 Date: July 4,2014

Debit Account: Furniture

Amount: ₹25000.



Notes

Credit Account

S.No.	Account Name	Amount (₹)	Narration (i.e. Explanation)
1.	Cash	15,000	Purchase of Office furniture from Modern Furniture. Cash paid. ₹15,000, for the Balance Liability created as per terms of purchase.
2.	Modern Furniture	10,000	

Authorised By: Prepared By:

Transfer Vouchers

With the expansion of business, the role of credit transactions is increasing at a fast pace. For recording of these credit transactions, a voucher is prepared known as transfer voucher. These transfer vouchers are prepared to record non-cash transactions of the business involving:

- Credit purchases
- Credit sales
- Return of goods sold
- Return of goods purchased on credit
- Depreciation on Assets
- Bad Debts etc.

These vouchers are prepared both in debit and credit forms simultaneously.

Firm Name

Transfer Voucher

Voucher No. : Date:

Amount:

Debit Account

S.No.	Account Name	Amount (₹)	Narration (i.e. Explanation)

Notes

Credit account

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*

Authorised By: Prepared By:

Fig. 4.4 Specimen of Transfer voucher

Illustration 3

Stationery Mart furnishes the following information:

April 1,2014

Opening Balances:

(i)	Cash	₹13000
(ii)	Bank	₹5000
(iii)	Furniture	₹22000
(iv)	Land and Building	₹125000
(v)	Trade Debtors :	
	Puneet	₹16000
	Mohan	₹14000
(vii)	Secured Bank Loan	₹70000
(viii)	Trade creditors:	
	Gopi	₹18000
	Sumit	₹24000
	Vipin	₹8000

Prepare transfer Voucher.

Solution :

Notes

Stationery Mart

Transfer Voucher

Voucher No. **Date: April 1,2014**

Amount:

Debit Account

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*
1	Cash	13000	Opening Balance
2	Bank	5000	Opening Balance
3	Furniture	22000	Opening Balance
4	Land and Building	125000	Opening Balance
5	Trade debtors:	30000	Opening Balance
	Puneet	16000	
	Mohan	14000	

Credit Account

S.No.	*Account Name*	*Amount (₹)*	*Narration (i.e. Explanation)*
1.	Secured Bank Loan		70000 Opening Balance
2	Trade creditors:		
	Gopi	18000	
	Sumit	24000	
	Vipin	8000	50000 Opening Balance
3	Capital	120000	Balancing Figure (i.e.240000-120000)

Authorised By: Prepared By:

INTEXT QUESTIONS 4.1

I. Classify the following into Business and Non-business Transactions:

i. Manav commences business with cash ₹200000.

ii. He deposited cash into bank ₹160000.

iii. He purchased goods for cash ₹25000.

Notes

iv. He took out cash from the shop and handed over to his wife for purchasing household goods ₹3000.

v. He attended a family function and got a gift worth ₹1500.

vi. He paid monthly salary to his business employees ₹3,000.

II. Fill in the blanks with suitable word or words:

i. The accounting vouchers are based on ....

ii. Invoice/bill is a .... document.

iii. Both debit and Credit aspects of a transaction are shown by .... Vouchers.

iv. A Credit voucher is prepared for .... receipts.

v. A debit voucher is prepared for .... payments.

4.2 ACCOUNTING EQUATION AND EFFECTS OF TRANSACTIONS ON IT

The recording of business transactions in the books of account is based on a fundamental equation called Accounting Equation. Whatever business possesses in the form of assets is financed by proprietor or by outsiders. This equation expresses the equality of assets on the one side and equity on the other side *i.e.,* the claims of outsider [liabilities] and owners or proprietors funds on the other side. In mathematical form,

Assets = Equity

Equity = Liabilities + Capital

As an asset is introduced in the business, a corresponding liability also emerges.

Effect of business transactions on accounting equation

These transactions increase or decrease the assets, liabilities, or capital. Every business has some assets. For example, Sunil started business with cash ₹3,00,000 as Capital. In this transaction, asset in the form of cash is created for the business. Hence,

Cash (Asset)		Capital (Equity)
₹3,00,000	=	₹3,00,000

Sunil purchased Machinery for ₹40,000 and Furniture for ₹20,000. Thus, the position of the assets and capital is as:

Cash	+	Machinery	+	Furniture	=	Capital
2,40,000	+	40,000	+	20,000	=	3,00,000

The above transaction shows that

> **Assets = Capital**
>
> **Or**
>
> **Capital = Assets**

Increase or decrease in capital will result in the corresponding increase or decrease in assets. For example Sunil withdrew cash for personal use ₹5,000. Thus, the position of the assets and capital is as under :

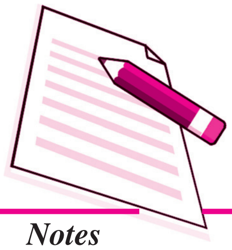
Cash	+	Machinery	+	Furniture	=	Capital
2,40,000	+	40,000	+	20,000	=	3,00,000
[–5,000]	+	0	+	0	=	[–5,000]
2,35,000	+	40,000	+	20,000	=	2.95.000

Business enterprise borrows money in the form of loan from outsiders to carry on its activities. In other words, every business concern owes money from outsiders. Money borrowed from outsiders is called as liability. For example, ₹1,50,000 were borrowed from Shipra. Thus, the position of the assets and capital will be as under

Cash	+	Machinery	+	Furniture	=	Liabilities	+	Capital
2,35,000	+	40,000	+	20,000	=	0		2,95,000
+1,50,000	+	0	+	0	=	1,50,000	+	0
3,85.000	+	40,000	+	20,000	=	1,50,000	+	2,95.000

The fact that business receives funds from proprietors and creditors and retains all of them in the form of assets, can be presented in the terms of an accounting equation as under

Assets	=	Liabilities	+	Capital	or	A= L+ C
			OR			
Liabilities	=	Assets	–	Capital	or	L= A – C
			OR			
Capital	=	Assets	–	Liabilities	or	C = A – L



Notes

Expenses and Revenue also affect the accounting equation. Their effect is always on the capital.

A business concern has to meet some expenses in its normal course of operations such as payment of salary, rent, insurance premium, postage, wages, repairs etc. Payment of these expenses reduces the cash. These expenses reduce the net income of the business. All the income is the income of proprietor, which is added in the capital account, so all these expenses are deducted from the capital. Similarly, business concern receives some revenues during normal course of operations, such as rent received, commission received, etc. Revenue is added to the cash balance as it is received in terms of cash. Revenue increases the net income of the business and hence, it is added to the capital. Now, the accounting equation is represented by

Assets	**=**	**Liabilities**	**+**	**Capital**
+ Revenue [Cash]	**=**		**+**	**Revenue**
– Expenses [Cash]	**=**		**–**	**Expenses**

Accounting equation is thus, affected by every business transaction. Any increase or decrease in assets, liabilities, and capital can be identified by preparing accounting equation. It shows that every business transaction satisfies the dual aspect concept of accounting. It also serves as the basis for preparing the Balance Sheet.

Effect of Transactions on the Accounting Equation

You have learnt that assets, liabilities and capital are the three basic elements of every business transaction, and their relationship is expressed in the form of accounting equation which always remains equal. At any point of time, there can be a change in the individual asset, liability or capital, but the two sides of the accounting equation always remain equal. Let us verify this fact by taking up some transactions and see how these transactions affect the accounting equation :

1. Namita started business with cash ₹3,50,000 introduced as capital. Thus the equation is as:

Assets	=	Liabilities	+	Capital
3,50,000	=	0	+	3,50,000

This transaction shows that ₹3,50,000 have been introduced by Namita in terms of cash, which is the capital for the business concern. Hence on one hand, the asset [cash] has been created to the extent of ₹3,50,000.

2. She purchased goods for cash ₹90,000.

Thus the accounting equation is as :

	Assets			=	Liabilities	+	Capital
	Cash	**+**	**Goods**				
old equation	3,50,000			=	0	+	3,50,000
Effect of Transaction	–90,000	+	90,000	=	0	+	0
New equation	2,60,000	+	90,000	=	0	+	3,50,000

Goods purchased is an asset and cash paid is also an asset. Hence in this transaction, there is an increase in one asset [Goods] and decrease in the other asset [cash]. There is no change in capital and liabilities. i.e. the other side of the accounting equation.

3. She purchased goods from Mohit for ₹60,000 on credit

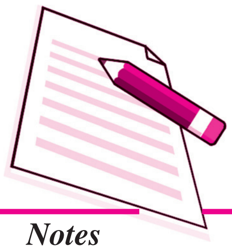
Thus the equation is as:

	Assets			=	Liabilities	+	Capital
	Cash	+	Goods				
Old equation	2,60,000	+	90,000	=	0	+	3,50,000
Effect of Transaction	0	+	60,000	=	60,000	+	0
New equation	2,60,000	+	1,50,000	=	60,000	+	3,50,000

In this transaction goods have been purchased on credit from Mohit , hence there is an increase in the assets [goods] by ₹60,000 and also an increase in the liabilities by ₹60,000 as the business concern now owes money to Mohit.

4. She sold goods to Anish for ₹40,000 (Cost ₹25,000) and received Cash ₹10,000 and balance after one month. Thus the accounting equation is as:

	Assets					=	Liabilities	+	Capital
	Cash	+	Goods	+	Debtors				
Old equation	2,60,000	+	1,50,000	+	0	=	60,000	+	3,50,000
Effect of Transaction	10,000	+	[–25,000]	+	30,000	=	0	+	15,000
New equation	2,70,000	+	1,25,000	+	30,000	=	60,000	+	3,65,000



Notes

In this transaction goods have been sold on credit and some on cash to Anish, so there is a decrease in the assets [goods] by ₹25,000, and increase in the assets (Anish) by ₹30,000 and [Cash] by ₹10,000. In this process the proprietor has gained an amount of ₹15,000 which is added to his capital.

5. She paid salaries to employees for ₹16,000.

	Assets					=	Liabilities	+	Capital
	Cash	+	Goods	+	Debtors				
Old equation	2,70,000	+	1,25,000	+	30,000	=	60,000	+	3,65,000
Effect of Transaction	[-16,000]	+	0	+	0	=	0	+	[–16,000]
New equation	2,54,000	+	1,25,000	+	30,000	=	60,000	+	3,49,000

In this transaction, salaries paid to employees are expenses for the business concern. Salaries are paid in terms of cash, hence cash as an asset is reduced by ₹16,000 and as all expenses reduce the capital, so capital is also reduced by ₹16,000.

From the above transactions, it is obvious that how every transaction has its effect on the accounting equation without disturbing the equality of the two sides of the equation.

Illustration 4

Prepare accounting equation from the following Transactions:

		₹
1.	Hemant started business with cash	3,00,000
2.	Purchased goods for cash	80,000
3.	Sold goods[costing ₹30,000] for	45,000
4.	Purchased goods from Monika	70,000
5.	Salary paid	7,000
6.	Commission received	5,000
7.	Paid Cash to Monika in full settlement	69,000
8.	Goods sold to Rahul {Costing ₹20,000} for	25,000

Solution

S. No.	Transaction	Assets: Cash	+	Assets: Goods	+	Assets: Debtors	= Total	Equity: Liabilities	+	Equity: Capital	Total
1.	Started business with cash	3,00,000	+	0	+	0	3,00,000	0	+	3,00,000	3,00,000
2.	Purchased goods for cash	-80,000	+	80,000	+	0		0	+	0	
	New Equation	2,20,000	+	80,000	+	0	3,00,000	0	+	3,00,000	3,00,000
3.	Sold goods for cash	45,000	+	-30,000	+	0		0	+	15,000	
	New Equation	2,65,000	+	50,000	+	0	3,15,000	0	+	3,15,000	3,15,000
4.	Purchased goods from Monika	0	+	70,000	+	0		70,000	+	0	
	New Equation	2,65,000	+	1,20,000	+	0	3,85,000	70,000	+	3,15,000	3,85,000
5.	Salary paid	-7,000	+	0	+	0		0	+	-7,000	
	New Equation	2,58,000	+	1,20.000	+	0	3,78,000	70,000	+	3,08,000	3,78,000
6.	Commission received	5,000	+	0	+	0		0	+	5,000	
	New Equation	2,63,000	+	1,20,000	+	0	3,83,000	70,000	+	3,13,000	3,83,000
7.	Paid Cash to Monika in full settlement	-69,000	+	0	+	0		–70,000	+	1,000	
	New Equation	1,94,000	+	1,20.000	+	0	3,14,000	0	+	3,14,000	3,14,000
8.	Goods sold to Rahul	0	+	-20,000	+	25,000		0	+	5,000	
	New Equation	1,94,000	+	1,00,000	+	25,000	3,19,000	0	+	3,19,000	3,19,000

Notes

Notes

Illustration 5

Prepare accounting equation from the following Transactions:

	₹
1. Nutan started business with cash	4,00,000
2. Purchased goods from Rohit	60,000
3. Sold goods[costing ₹25,000] for cash	22,000
4. Purchased goods for cash	50,000
5. Salary outstanding	3,000
6. Rent received	6,000
7. Paid Cash to Rohit on account	35,000
8. Goods sold to Bharti {Costing ₹30,000} for	40,000

INTEXT QUESTIONS 4.2

Fill in the blanks with suitable word/words:

i. Accounting equation satisfies the .... concept of accounting.

ii. Assets = ... + Liabilities

iii. Capital = Assets – ....

iv. Accounting Equation serves as a basis for preparing ....

v. Liabilities = ... – Capital

4.3 RULES OF ACCOUNTING

Using Debit and Credit

In Double Entry accounting both the aspects of the transaction are recorded. Every transaction has two aspects and according to this system, both the aspects are recorded. If the business acquires something, it must have been acquired by giving something. While recording each transaction, the total amount debited must be equal to the total amount credited. The terms 'Debit' and 'Credit' indicate whether the transaction is to be recorded on the left hand side or right hand side of the account. In its simplest form, an account looks like the English Language Letter 'T'. Because of its shape, this simple form of account is called T-account (refer figure 4.5) . Have you observed that

Notes

Solution : (Illustration 5)

S.No	Transaction	Assets					=	Equity			
		Cash		Goods		Debtors	Total	Liabilities		Capital	Total
1.	Started business with cash	4,00,000	+	0	+	0	4,00,000	0	+	4,00,000	4,00,000
2.	Purchased goods from Rohit	0	+	60,000	+	0		60,000	+	0	
	New Equation	4,00,000	+	60,000	+	0	4,60,000	60,000	+	4,00,000	4,60,000
3.	Sold goods for cash	22,000	+	[-25,000]	+	0		0	+	[-3,000]	
	New Equation	4,22,000	+	35,000	+	0	4,57,000	60,000	+	3,97,000	4,57,000
4.	Purchased goods for cash	[-50,000]	+	50,000	+	0		0	+	0	
	New Equation	3,72,000	+	85,000	+	0	4,57,000	60,000	+	3,97,000	4,57,000
5.	Salary outstanding	0	+	0	+	0		3,000	+	[-3,000]	
	New Equation	3,72,000	+	85,000	+	0	4,57,000	63,000	+	394,000	4,57,000
6.	Rent received	6,000	+	0	+	0		0	+	6,000	
	New Equation	3,78,000	+	85,000	+	0	4,63,000	63,000	+	4,00,000	4,63,000
7.	Paid Cash to Rohit on account	[-35,000]	+	0	+	0		[-35,000]	+	0	
	New Equation	3,43,000	+	85,000	+	0	4,28,000	28,000	+	4,00,000	4,28,000
8.	Goods sold to Bharti	0	+	[–30000]	+	40,000		0	+	10,000	
	New Equation	3,43,000	+	55,000	+	40,000	4,38,000	28,000	+	4,10,000	4,38,000

the 'T' format has a left side and a right side for recording increases and decreases in the item? This helps in ascertaining the ultimate position of each item at the end of an accounting period. For example, if it is an account of a supplier all goods/materials supplied shall appear on the right (Credit) side of the Supplier's account and all payments made on the left (debit) side.

In a 'T' account, the left side is called debit (usually abbreviated as Dr.) and the right side is known as credit (as usually abbreviated Cr.).

Account Title

(Left Side) (Right Side)

Fig.4.5: Specimen of T-account.

Rules of Accounting

All accounts are divided into five categories for the purpose of recording of the business transactions:

(i) Assets, (ii) Liability, (iii) Capital,

(iv) Expenses/Losses, and (v) Revenues/Gains.

Two Fundamental Rules are followed to record the changes in these accounts:

1. For recording changes in Assets/Expenses/Losses

"Increase in Asset is debited, and decrease in Asset is credited."

"Increase in Expenses/Losses is debited, and decrease in Expenses/Losses is credited."

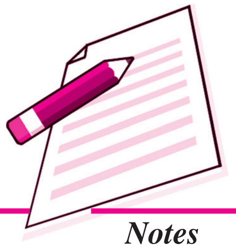
2. For recording changes in Liabilities and Capital/Revenue/Gains

"Increase in Liabilities is credited and decrease in Liabilities is debited."

"Increase in Capital is credited and decrease in Capital is debited."

"Increase in revenue/gains is credited and decrease in revenue/gain is debited".

The rules applicable to the five kinds of accounts are summarised in the following chart:



Notes

Rules of Accounting

Assets

(Increase)	(Decrease)
+	–
Debit	Credit

Liabilities

(Decrease)	(Increase)
–	+
Debit	Credit

Capital

(Decrease)	(Increase)
–	+
Debit	Credit

Expenses/Losses

(Increase)	(Decrease)
+	–
Debit	Credit

Revenue/Gains

(Decrease)	(Increase)
–	+
Debit	Credit

I. Analysis of Rule Applied to Assets Accounts

Rohan Purchased Furniture for ₹80,000.

Analysis of Transaction : In this transaction, the affected accounts are Cash account and Furniture account. Cash account is an assets account and has decreased. As per rule if asset decreases the affected account is credited, so cash account credited. Furniture is also an asset and it has increased. As per rule asset if increases the affected account is debited thus, furniture account is debited.

Cash

	Decrease
	80,000
	[–] Credit

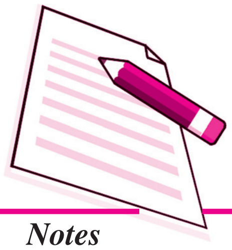
Furniture

Increase	
80,000	
[+] Debit	

II. Analysis of Rule Applied to Liabilities Accounts:

Purchased Machinery for ₹60,000 on credit from M/s Indian Machinery Mart.

Analysis of Transaction: In this transaction, the two accounts affected are machinery and M/s Indian Machinery Mart. Machinery is an asset, an asset has increased, therefore machinery account is debited. M/s Indian Machinery Mart is the creditor on account of supply of machinery and constitutes, the liability for the buying firm which



Notes

has increased. Rule is that on increase of liability the concerned account is credited and vice-versa. Thus, M/s Indian Machinery Mart A/c is credited.

M/s Indian Machinery Mart [Liability]		Machinery (Assets)	
	Increase	Increase	
	60,000	60,000	
	[+] Credit	[+] Debit	

III. Analysis of Rule Applied to Capital Accounts:

Cash of ₹50,000 introduced in business as Capital by Rakesh.

Analysis of Transaction: In this transaction, the two account affected are Cash account and Rakesh [Capital account] . Cash is an asset and Rakesh invested capital. Rule for Capital is that if it increases the account is credited and vice-versa. So, here capital account is credited.

Capital [Rakesh] Account		Cash (Assets)	
	Increase	Increase	
	50,000	50,000	
	[+] Credit	[+] Debit	

IV. Analysis of Rule Applied to Expenses/Losses Accounts:

Paid ₹6000 to the employees as Salary.

Analysis of Transaction: In this transaction, the two accounts affected are salary account and Cash account. Salary account is an expense and has increased. Cash is an asset and has decreased. Rule regarding expenses/losses is that if it increases the account is debited.

Salary Account [Expenses]		Cash (Assets)	
Increase			Decrease
6,000			6,000
[+] Debit			Credit [-]

V. Analysis of Rule Applied to Revenue/Profit Accounts:

Received interest for the month ₹4000.

Analysis of Transaction: In this transaction, the two accounts affected are Interest and Cash. Interest is an item of Income and Cash an item of asset. Rule regarding Revenue/profit is, increase in revenue is credited. Cash is an asset and rule for assets is increase in assets is debited.

Interest Account [Revenue]		Cash (Assets)	
	Increase	Increase	
	4,000	4,000	
	[+] Credit	[+] Debit	

Notes

Illustration 6

From the following transactions, state the titles of the accounts to be affected, types of the accounts and the account to be debited and the account to be credited:

		₹
1.	Ankur started business with cash	600000
2	Purchased goods for cash	80000
3.	Paid salaries	10000
4.	Sold goods to Rohit on credit	60000
5	Office machine purchased for cash	12000
6	He took loan from Bank	30,000
7	He received commission	4,000
8.	Postage paid	500
9.	Paid rent	6,000
10	Received cash from Rohit	60000

Solution

Trans-action No	*Names of accounts*		*Type of accounts*		*Rules applicable to A/cs in Debit/Credit items of Increase/Decrease*	
	(1)	*(2)*	*(1)*	*(2)*	*(1)*	*(2)*
1	Cash	Capital	Asset	Capital	Cash (Increase)	Capital (Increase)
2	Purchases	Cash	Expense	Asset	Purchase (")	Cash (decrease)

Notes

3	Salaries	Cash	Expense	Asset	Salaries (")	Cash (decrease)
4	Rohit	Sales	Asset Debtor	Revenue	Rohit (")	Sales (Increase)
5	Office machine	Cash	Asset	Asset	Office (") machine	Cash (decrease)
6	Cash	Bank laon	Asset	Liability	Cash (Increase)	Bank loan (Increase)
7	Cash	Commi-ssion	Asset	Revenue	Cash (Increase)	Commission (Increase)
8	Postage	Cash	Expense	Asset	Printing and Stationery (Increase)	Cash (decrease)
9	Rent	Cash	Expense	Asset	Rent (Increase)	Cash (decrease)
10	Cash	Rohit	Asset	Asset	Cash (Increase)	Rohit (decrease

INTEXT QUESTIONS 4.3

A list of the accounts is given below. Tick the category to which each of the account belongs:

Type of Account

	Name of Account	*Asset*	*Liability*	*Capital*	*Revenue*	*Expense*
i.	Wages					
ii.	Building					
iii.	Office Machine					
iv.	Cash					
v.	Mohan (Supplier)					
vi.	Krishan (Owner)					
vii.	Radha (Customer)					
viii.	Interest received					
ix.	Bank Overdraft					
x.	Commission Earned					
xi.	Discount allowed					

4.4 BASIS OF ACCOUNTING

As we are aware that one of the most significant functions of accounting is to make us know true and fair amount of profit earned by the business entity in a particular period. This Profit or income figure can be ascertained by following

(i) Cash Basis of accounting

(ii) Accrual Basis of accounting

(iii) Hybrid Basis of accounting

I. Cash Basis of accounting

This is a system in which accounting entries are recorded only when cash is received or paid. Revenue is recognized only on receipt of cash. Similarly, expenses are recorded as incurred when they are paid. The difference between the total revenues and total expenses represents profit or loss of an enterprise for a particular accounting period. Outstanding and prepaid expenses and income received in advance or accrued incomes are not considered.

Advantages

Following are the advantages of adopting cash basis of accounting:

- It is very simple as no adjustment entries are required.
- It appears more objective as very few estimates and personal judgments are required.
- It is more suitable to those entities which have most of the transactions on cash basis.

Disadvantages

Following are the disadvantages of adopting cash basis of accounting:

- It does not give a true and fair view of profit and loss and the financial position of the business unit as it ignores outstanding and prepaid expenses.
- It does not follow the matching concept of accounting.

Illustration 7

During the financial year 2013-14, Mela Ram had cash sales of ₹580000 and credit sales of ₹265000. His expenses for the year were ₹.460000 out of which ₹60000 are still to be paid. Find out Mela Ram's Income for the year 2013-14 following the cash basis of accounting.

Notes

Solution:

	Amount (₹)
Revenue (in terms of Cash Inflows)	580000
Less: Expenses (Outflow of cash) (i.e. ₹ 460000- 60000)	400000
Net Income	180000

Note : Credit Sales and Outstanding Expenses are not to be considered under cash basis of accounting.

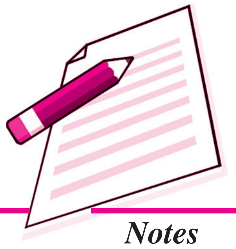
II. Accrual Basis of accounting

Revenue and expense are taken into consideration for the purpose of income determination on the basis of accounting period to which they relate. The accrual basis makes a distinction between actual receipts of cash and the right to receive cash for revenues and the actual payment of cash and the legal obligation to pay expenses. It means the income accrued in the current year becomes the income of the current year whether the cash for that item is received in the current year or it was received in the previous year or it will be received in the next year. The same is true of expense items. Expense item is recorded if it becomes payable in the current year whether it is paid in the current year or it was paid in the previous year or it will be paid in the next year. For example, credit sales are included in the total sales of the period irrespective of the fact when cash on account is received. Similarly, in case the firm has taken benefit of a certain service, but has not paid within that period, the expense will relate to the period in which the service has been utilized and not the period in which the payment for it is made.

Outstanding Expenses are those expenses which have become due during the accounting period but which have yet not been paid off. Prepaid Expenses are those expenses which have been paid in advance. Accrued Income means income which has been earned by the business during the accounting period but has not yet become due for payment and therefore has not yet been received. Income received in advance means income which has been received by the business before being earned. Costs incurred during a particular period should be set out against the revenue of the period to ascertain profit or loss.

Following are the advantages :

- It is based on all business transactions of the year and discloses correct profit or loss.
- This method is used in all types of of business units.
- It is more scientific and rational in application.



Notes

Following are the disadvantages :

- It is not simple one and requires the use of estimates and personal judgment.
- It fails to disclose the actual cash flows.

Illustration 8

Taking the data given in the Illustration 7, find out the net income of Mela Ram as per accrual basis of accounting.

Solution

	Amount (₹)
Total Sales:	
Cash Sales (₹ 580000) + Credit Sales (₹ 265000)	845000
Less: Total Expenses for the year 2013-14	460000
Net Income	385000

Note: Outstanding Expenses of ₹60,000 relate to this accounting year and hence are to be charged to the revenues of current year. Similarly, credit sales of ₹2,65,000 are considered for this year as the transaction took place during this current year.

Difference between accrual basis of accounting and cash basis of accounting

Basis of Difference	*Accrual Basis of accounting*	*Cash Basis of accounting*
1. Prepaid, Outstanding and received in advance items	There may be outstanding expense, prepaid expenses, accrued income and income received in advance in the Balance sheet.	There is no outstanding expense, prepaid expenses, accrued income and income received in advance in the Balance Sheet
2. Effect on income of prepaid expenses and accrued income	Income statement will show relatively higher income if there are items of prepaid expenses and accrued income.	Income statement will show relatively lower income if there are items of prepaid expenses and accrued income
3. Effect of outstanding expenses and unearned income	Income statement will show a lower income if there are items of outstanding expenses and unearned income	Income statement will show a higher income if there are items of outstanding expenses and unearned income
4. Legal Position	Companies Act 1956 recognizes this basis of accounting.	Companies Act 1956 does not recognize this basis of accounting.

Notes

5. Option regarding valuation of inventories and methods of depreciation	The business unit has the option to value the inventories at cost or market, whichever is less of depreciation.	No such option is available in regard to inventory valuation and method of depreciation.
6. Reliable	It is a reliable basis of accounting as it records all cash as well credit transactions. It ascertains true profit or loss.	It is not a reliable basis of accounting as only cash transactions are recorded. It fails to ascertain true profit or loss.
7. Users	A business unit with a profit motive ascertains its profit or loss as per accrual basis.	Professional people, small ventures of temporary nature, some Not- for-Profit Organizations ascertain their profit or loss as per cash basis.

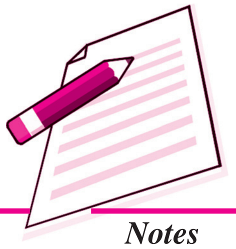
III. Hybrid Basis of Accounting

Both cash basis of accounting and accural basis of accounting have their own advantages and limitations. Cash Basis of Accounting can be used only in units which deal exclusively in cash and are very small in size. These days the number of transactions undertaken by an enterprise are very large and are for cash as well as on credit. Hence, an accounting system which is the combination of both cash as well as accural basis is in use. This system is called hybrid basis of accounting. It has advantages of both the systems and is able to eliminate disadvantages of the both the system.

4.5 DOUBLE ENTRY MECHANISM

Double Entry Mechanism entails recording of transactions keeping in mind the debit and credit aspect of the transaction. To record every transaction, one account is debited and the other is credited. This is based on the principle 'every debit has a credit'. The Double entry Book-Keeping seeks to record every transaction in money or money's worth in its dual aspect. The advantages of double entry mechanism are :

- Systematic Record: It records, classifies, and synthesizes the business transaction in a systematic manner. It provides reliable information for sound decision making. It meets the needs of users of accounting information.
- Complete Record: It maintains complete record of a business transaction. It records both the aspects of the transaction with narration.
- Accurate records: By Preparing a Summarised Statement of Account the arithmetical accuracy of the records can be checked.



Notes

- Operational Results: By preparing Income Statement (Profit and Loss Account) the business can know profit or loss due to its operations during an accounting period.
- Financial Position: By preparing Position Statement (Balance Sheet) the business can know what it owns and what it owes to others. What are its assets and what are its Liabilities and Capital.
- Possibility of Fraud: Possibility of Frauds is minimized as complete information is recorded under this system.

INTEXT QUESTIONS 4.4

I. Answer the following with reference to cash basis of accounting

i. How it is simple?

As ______________________________

ii. How it is more objective?

As ______________________________

iii. To which business with it is more suitable?

Which ______________________________

iv. Which is the concept of accounting it does not follow?

The ______________________________

v. Credit sales of ₹10000 taken into account for calculating profit.

II. State whether the following statements are True or False :

i. Creditors are the internal users of accounting information.

ii. Management are the internal users of accounting information.

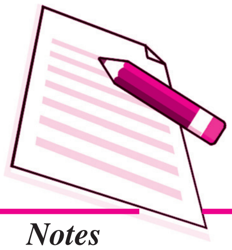
iii. Hybrid basis of accounting has advantages of both the systems (Cash & Accural) of accounting.

III. Answer the following question referring to double entry mechanism:

i. How possibility of frauds are minimised.

ii. How can arithmetical accuracy of the records can be checked?

iii. Name the concept on which to record every transaction one account is debited and other is credited is based.



Notes

WHAT YOU HAVE LEARNT

- **Business Transaction :** A business transaction is a transaction, which involves exchange of values between two parties. Every transaction involves Give and Take aspect.

- **Source Documents and vouchers :** All business transactions are based on documentary evidence. A Cash memo showing cash sale, an invoice showing sale of goods on credit, the receipt made out by the payee against cash payment, are all examples of source documents. A Voucher is documentary evidence in support of a transaction.

- **Types of Accounting Vouchers :** Accounting vouchers are the written documents, containing the analysis of business transactions for accounting and recording purpose.

Types of Accounting Vouchers

- Cash Voucher
  - Debit vouchers
    - [For Cash Payments]
  - Credit vouchers
    - [For Cash Receipts]
- Non-Cash Voucher
  - [Transfer vouchers]
    - [For Non-cash Transaction]

- **Accounting Equation :** The recording of business transaction in the books of account is based on a fundamental equation called Accounting Equation.

Assets = liabilities + Capital

- **Rules of Accounting**

Using Debit and Credit

Two Fundamental Rules are followed to record the changes in these accounts:

For recording changes in Assets/Expenses/Losses

"Increase in Asset is debited, and decrease in Asset is credited."

"Increase in Expenses/Losses is debited, and decrease in Expenses/Losses is credited."

For recording changes in Liabilities and Capital/Revenue/Gains

"Increase in Liabilities is credited and decrease in Liabilities is debited."

"Increase in Capital is credited and decrease in Capital is debited."

"Increase in revenue/gains is credited and decrease in revenue/gain is debited".

- There can be three basis of Accounting (i) Cash basis (ii) Accrual basis and (iii) Hybrid Basis

  In cash basis accounting entries are recorded only when cash is received or paid.

  In accrual basis of accounting revenue and expense are taken into consideration for the purpose of income determination on the basis of accounting period to which they relate.

- **Hybrid Basis :** This is an accounting system which is the combination of both cash as well as on credit.

  Double Entry Book Keeping Mechanism: Double Entry Book Keeping Mechanism entails recording of transactions keeping in mind the debit and credit aspect of the transaction.

Notes

TERMINAL EXERCISE

1. State the meaning of business transaction.
2. What is meant by accounting voucher ? Explain in brief different types of accounting vouchers.
3. State the fundamental rules followed to record the changes in various accounts.
4. Explain in brief cash basis of accounting and differentiate it with accrual basis of accounting.
5. What is meant by double entry mechanism? Give its advantages.
6. "Accounting equation remains intact under all circumstances" Justify the statement with the help of examples.
7. Prepare accounting equation on the basis of the following :

   (i) Anup started business with cash ₹ 2,50,000

   (ii) Purchased goods for cash ₹ 35,000

   (iii) Purchased office furniture for cash ₹ 12,000

   (iv) Paid rent ₹ 7,000

Notes

(v) Sold goods (costing ₹ 30,000) for ₹ 50,000 for cash

8. Show the accounting equation on the basis of the following transactions :

		₹
(i)	Manu started business	
	Cash	6,00,000
	Goods	1,00,000
(ii)	Purchased office machine for cash	90,000
(iii)	Sold goods (costing ₹ 60000) for credit to Asha	70,000
(iv)	Purchased building for cash	1,30,000
(v)	Cash received from Ashu	80,000
(vi)	Purchased goods on credit from M/S Ashok Traders	70,000
(vii)	Salaries paid	6,000
(viii)	Insurance prepaid	10,000
(ix)	Cash paid to M/s Ashok Traders in full settlement	68,000

9. Prepare necessary accounting vouchers from the following transactions:

(i) Building purchased for ₹ 6,00,000

(ii) Goods sold on credit to M/s Reema Trader ₹ 1,10,000

(iii) Salary paid to ₹ 1,00,000

(iv) Withdrew cash for personal use ₹ 6,000

(v) Cash receipts from debtors M/s Ankit Bros ₹ 22,000

ANSWERS TO INTEXT QUESTIONS

4.1 I.

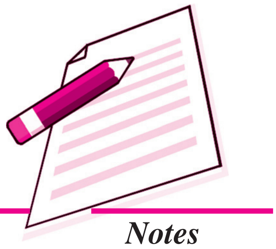
Business transactions	**Non-business transactions**
(i), (ii), (iii)	(vi), (iv), (v)

II. (i) supporting document (ii) source (iii) Transfer

(iv) Cash (v) Cash

4.2 (i) Dual (ii) Capital (iii) Liabilities

(iv) Balance sheet (v) Assets



Notes

4.3

	Asset	Liability	Capital	Revenue	Expense
(i)					√
(ii)	√				
(iii)	√				
(iv)	√				
(v)		√			
(vi)			√		
(vii)	√				
(viii)				√	
(ix)			√		
(x)				√	
(xi)					√

4.4 I. (i) No adjustment entries are required
(ii) Very few estimates and personal judgement are required.
(iii) Have most of the transactions on cash basis
(iv) Matching concept
(v) Should not

II. (i) False (ii) True (iii) True

III. (i) As complete information is recorded under this system
(ii) By preparing summarised statement of account.
(iii) Every debit has a credit.

ANSWERS TO TERMINAL EXERCISE

7. Assets Cash ₹ 2,46,000 + Goods ₹ 5,000 + Office furniture ₹ 12,000 = Capital ₹ 2,63,000

8. Assets cash ₹ 3,76,000 + Goods ₹ 1,10,000, Office machine ₹ 90,000 + Building ₹ 1,30,000 + Prepaid insurance ₹ 10,000 = liabilities ₹ 7,16,000

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5

JOURNAL

In the preceeding lessons you have learnt about various business transactions and Book keeping i.e. recording these transactions in the books of accounts in a systematic manner. Curosity may arise in your mind that what are these books? Why businessman keeps many books? How does he records various transactions in these books? You have learnt about the double entry system of maintaining accounts i.e. rules of debit and credit in relation to various accounts. A book that is prepared by every businessman, small or big. is a book in which business transactions are recorded datewise and in the order in which these transactions take place is known as journal. In this lesson you will learn about its meaning, objectives and its preparation.

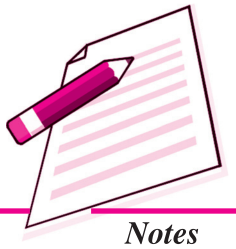
OBJECTIVES

After studying this lesson, you will be able to :

- explain the meaning of journal;
- draw format of Journal;
- explain the process of journalising;
- journalise the simple and compound transactions;
- classify journal into Special Journals and Journal Proper.

5.1 JOURNAL : MEANING AND FORMAT

Journal is a book of accounts in which all day to day business transactions are recorded in a chronological order i.e. in the order of their occurence. Transactions when recorded in a Journal are known as entries. It is the book in which transactions are recorded for the first time. Journal is also known as 'Book of Original Record' or 'Book of Primary Entry'.



Notes

Business transactions of financial nature are classified into various categories of accounts such as assets, liabilities, capital, revenue and expenses. These are debited or credited according to the rules of debit and credit, applicable to the specific accounts. Every business transaction affects two accounts. Applying the principle of double entry, one account is debited and the other account is credited. Every transaction can be recorded in journal. This process of recording transactions in the journal is' known as 'Journalising'.

In small business houses generally one Journal Book is maintained in which all the transactions are recorded. But in case of big business houses as the transactions are quite large in number, therefore journal is divided into various types of books called Special Journals in which transactions are recorded depending upon the nature of transaction i.e. all credit sales in Sales Book, all cash transactions in Cash Book and so on.

Format of Journal

Every page of Journal has the following format. It is a columnar book. Each column is given a name written on its top. Format of journal is given below:

Journal

Date	*Particulars*	*Ledger Folio*	*Dr. Amount (₹)*	*Cr. Amount (₹)*
(1)	(2)	(3)	(4)	(5)

Column wise details of journal is as :

1. Date

In this column, we record the date of the transactions with its month and accounting year. We write year only once at the top and need not repeat it with every date.

Example :

Date

2014

April 15

2. Particulars

The accounts affected by a transaction i.e the accounts which have to be debited or credited are recorded in this column. It is recorded in the following way :

In the first line, the account which has to be debited is written and then the short form of Debit i.e. Dr. is written against that account's name in the extreme right of the same column.

In the second line after leaving some space from the left of the entry in the first line, the account which has to be credited is written starting with preposition 'To'. Then in the third line, Narration for that entry which explains the transaction, the affected accounts of which are entered, is written within Brackets. Narration should be short, complete and clear. After every journal entry, horizontal line is drawn in the particulars column to separate one entry from the other.

Example : Rent paid in cash on 1st April, 2014

Date	Particulars
2014	Rent A/c .... Dr
April 1	To Cash A/c ....
	(Rent paid in cash)

3. Ledger Folio

The transaction entered in a Journal is posted to the various related accounts in the 'ledger' (which is explained in another lesson). In ledger-folio column we enter the page-number where the account pertaining to the entry is opened and posting from the Journal is made.

4. Dr. Amount

In this column, the amount to be debited is written against the same line in which the debited account is written.

5. Cr. Amount

In this column, the amount to be credited. is written against the same line in which the credited account is written.

Example : Paid ₹ 4,000 rent on 1st April 2014.

Journal

Date	*Particulars*	*L.F.*	*Dr. Amount (₹)*	*Cr. Amount (₹)*
2014 April 1	Rent A/c .... Dr		4000	
	To Cash A/c			4000
	(Rent paid in Cash)			

At the end of each page, both the Dr. and Cr. columns are totalled up. The total of both these columns should be equal as the same amount is entered in the debit as well as in the credit columns. The totals are carried forward to the next page with the words 'total carried forward (c/f) and then at the top of the next page in Particulars column, we write totals brought forward (b/f) and the amount of totals is written in the respective amount columns.

INTEXT QUESTIONS 5.1

I. What is journal? Write in your own words.

....

....

II. Complete the following sentences with the appropr:ate word/words:

i. Journalising is the process of entering transactions in

ii. Another name for Journal is ....

iii. Transactions, when recorded in Journal, are known as ....

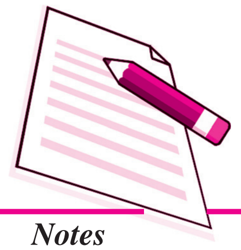
iv. The explanation of a Journal entry is known as ....

v. In a Journal entry preposition .... is used before the name of the account to be credited

5.2 PROCESS OF JOURNALISING

Following steps are taken for the preparation of a journal :

- **Identify the Accounts :** First of all, the affected accounts of an accounting transaction are identified. For example, if the transaction of "goods worth ₹10000



are purchased for Cash", then 'Purchases' A/c and 'Cash' A/c are the two affected accounts.

- **Recognise the type of Accounts :** Next we determine the type of the affected accounts e.g. in the above case, 'Purchases A/c and Cash A/c are expense and asset account respectively.
- **Apply the Rules of Debit and Credit :** Then the rules of 'debit' and 'credit' are applied to the affected accounts. You are aware of these rules. However, for the revision purposes, these are given below :

  (a) Assets and Expenses Accounts are debited if there is an increase and credited if there is decrease :

  (b) Liability, Capital and Revenue Accounts are debited if there is decrease and credited if there is increase.

In the example given when goods are purchased, as the assets are increasing, therefore, Purchases Account will be debited and as payment is made in cash, assets are decreasing, Cash Account will be credited.

Now, the journal entry will be made in the Journal alongwith a brief explanation i.e. narration. The corresponding amounts will be written in the debit and credit columns. After completing one entry, an horizontal line is drawn before entry for the next transaction is made in the journal.

The transaction, given above in the example, is journalised in the following manner:

Date	*Particulars*	*L.F.*	*Dr. Amount (₹)*	*Cr. Amount (₹)*
	Purchases A/c .... Dr		10000	
	To Cash A/c			10000
	(Goods purchased for Cash)			

Illustration 1

Analyse in Tabular form and Enter the following transactions in the Journal of Bhagwat and Sons

2014		₹
January 1	Tarun started business with cash	1,00,000
January 2	Goods purchased for cash	20,000
January 4	Machinery Purchased from Vibhu	30,000

Notes

January 6	Rent paid in cash	10,000
January 8	Goods purchased on credit from Anil	25,000
January 10	Goods sold for cash	40,000
January 15	Goods sold on credit to Gurmeet	30,000
January 18	Salaries paid.	12,000
January 20	Cash withdrawn for personal use	5,000

Solution

As explained above, before making the journal entries, it is very essential to determine the kind of accounts to be debited or credited. This is shown in the Table :

Tabular Analysis of Business Transactions

Date	*Transaction*	*Affected Accounts*	*Kind of Accounts*	*Increaseor Decrease in Accounts*	*Debited Accounts Dr.*	*Credited Accounts Cr.*
2014 Jan.1	Cash received from the owner Tarun	Cash Capital	Asset Capital	Increase Increase	Cash A/c	Capital A/c
Jan. 2	Goods purcha-ses for cash	Goods Cash	Asset Asset	Increase Decrease	Purchases A/c	Cash A/c
Jan. 4	Machinery purchased on Credit from Vibhu	Machinery Vibhu	Asset Liability	Increase Increase	Machinery A/c	Vibhu A/c
Jan. 6	Rent paid in cash	Rent Cash	Expense Asset	Increase Decrease	Rent A/c	Cash A/c
Jan. 8	Goods on purchased Credit from Anil	Purchases Anil (creditor)	Asset Liability	Increase Increase	Purchases A/c	Anil A/c
Jan.10	Goods sold for cash Cash	Cash sales	Asset Revenue	Increase Increase	Cash A/c	Sales A/c
Jan.15	Credit sales to Gurmeet	Gurmeet (Debtor) Sales	Asset Revenue	Increase Increase	Gurmeet	Sales A/c
Jan.18	Salaries paid in cash	Salaries Cash	Expense Asset	Increase Decrease	Salaries A/c	Cash A/c

Notes

Jan.20	Cash withdrawn for personal use	Drawings Cash	Capital Asset	Decrease Decrease	Drawings A/c	Cash A/c

On the basis of the above table, following entries can be made in the Journal

Journal of Tarun

Date	*Particulars*		*L.F.*	*Dr. Amount* ₹	*Cr. Amount* ₹
2014					
Jan. 1	Cash A/c	Dr.		1,00,000	
	To Tarun Capital A/c				1,00,000
	(Capital brought in by Tarun)				
Jan. 2	Purchases A/c	Dr.		20,000	
	To Cash A/c				20,000
	(Goods purchased for Cash)				
Jan. 4	Machinery A/c	Dr.		30,000	
	To Vibhu's A/c				30,000
	(Machinery purchased from Vibhu on credit)				
Jan. 6	Rent A/c	Dr.		10,000	
	To cash A/c				10,000
	(Rent paid)				
Jan. 8	Purchases A/c	Dr.		25,000	
	To Anil's A/c				25,000
	(Good purchased on credit)				
Jan.10	Cash A/c	Dr.		40,000	
	To Sales A/c				40,000
	(Goods sold for Cash)				
Jan.15	Gurmeet's A/c	Dr.		30,000	
	To Sales A/c				30,000
	(Goods sold on credit to Gurmeet)				
Jan.18	Salaries A/c	Dr.		12,000	
	To Cash A/c				12,000
	(Salaries paid)				
Jan.20	Drawings A/c	Dr		5,000	
	To Cash A/c				5,000
	(Cash withdrawn by the owner for personal use)				
	Total			**2,72,000**	**2,72,000**

Notes

INTEXT QUESTIONS 5.2

I. Below are given certain transactions. Write the names and kinds of affected accounts in the given columns of debit and credit :

Transaction	Dr.		Cr	
	Name of A/c	*Type of A/c*	*Name of A/c*	*Type of A/c*
i. Started business with cash	Cash A/c	Assets	Capital	Capital
ii. Credit purchases of goods				
iii. Commission paid by cheque				
iv. Cash deposited into Bank				
v. Interest received in cash				
vi. Furniture purchased from Mukesh				
vii. Goods sold by Ramesh				

II. Write down the narration for the following Journal entries in the space provided :

(i) Cash A/c Dr.
To sales A/c
( )

(ii) Purchases A/c Dr.
To Vinay's A/c
( )

III. Complete the following journal entries :

(i) Amit's A/c Dr.
To .... A/c
(Goods sold to Amit)

(ii) .... Dr.
To Cash A/c
(Commission paid in Cash)

(iii) Cash A/c Dr.
To .... A/c
(Interest received in Cash)

(iv) Goods A/c Dr
To .... A/c
(Goods purchased from Rohit for Cash)

5.3 COMPOUND AND ADJUSTING ENTRIES

The journal entries that you have learnt so far are simple and affect two accounts only. There can be entries that affect more than two accounts; such entries are called compound or combined entries.

A simple journal entry contains only one debit and one credit. But if an entry contains more than one debit or credit or both, that entry is known as a compound journal entry. Actually, a compound journal entry is a combination of two or more simple journal entries.

Thus, a compound journal entry can be made in the following three ways:

(i) By debiting one account and crediting more than one account.

(ii) By debiting more than one account and crediting one account.

(iii) By debiting more than one account and also crediting more than one account.

Two simple journal entries are as :

Journal

Date	*Particulars*		*L.F.*	*Dr. Amount ₹*	*Cr. Amount ₹*
2014					
Nov. 30	Salary A/c	Dr.		6,000	
	To Cash A/c				6,000
	(Salary paid in Cash)				
Nov. 30	Rent A/c	Dr.		12,000	
	To Cash A/c				12,000
	(Rent paid in Cash)				

The above two simple entries have been converted into compound Journal entry as under :

2014					
Nov. 30	Salary A/c	Dr.		6,000	
	Rent A/c	Dr.		12,000	
	To Cash A/c				18,000
	(Payment of Salary and Rent in Cash)				

Note : To make the compound entry, it is necessary that the transactions must be of the same date and one account is common.

If you match the first two simple entries with the converted compound entry, you will find that there is no difference between them so far as the accounting effect is concerned. The compound entries save time and space. Such compound entries are made in the following cases:

(a) When two or more transactions occur on the same day.

(b) One aspect i.e. either the Debit account or Credit account is common.

A few more examples of compound entries are :

1. Bad Debts

When a debtor fails to pay the full amount due to him, the unpaid amount is known as bad debts.

For example, A business concern receives ₹ 8000 out of ₹ 10,000 due from Harish. He is unable to pay the balance amount, thus, the remaining amount becomes a bad debts for the business.

The compound entry for this transaction will be :

Bank A/c	Dr.	8,000	
Bad Debts A/c	Dr.	2,000	
To Harish's A/c			10,000
(Receipt of ₹ 8,000 from Harish and remaining due amount of ₹ 2,000 is treated as bad debts)			

2. Discount Allowed and Received

To encourage a customer to pay the amount due before due date, discount is allowed. This is called cash discount. If such discount is received the compound entry will be :

a) Creditor A/c Dr.

  To Bank A/c

  To Discount A/c

b) Similarly, when cash discount is allowed, the journal entry will be

Bank A/c Dr.

Discount A/c Dr.

  To customer's (Debtor's) A/c

Note : When the customer buys goods in bulk or in large quantity some discount may be allowed to him. This is to encourage him to buy more and more. This discount is called Trade Discount. When the bill is prepared for the purchase of goods, the amount of trade discount is deducted from the total amount payable. No entry is made for this type of discount in the journal i.e. it is not recorded in the books of accounts.

Illustration 2

Enter the following transactions in the books of Supriya, the owner of the business:

2014

Jan. 8	Purchased goods worth ₹ 5,000 from Sarita on credit.
Jan. 12	Neha Purchased goods worth ₹ 4,000 from Supriya on credit.
Jan. 18	Received a Cheque from Neha in full settlement of her account ₹3,850.
	Discount allowed to her ₹150
Jan. 20	Payment made to Sarita ₹ 4,900. Discount allowed by him ₹ 100.
Jan. 22	Purchased goods for cash ₹ 10,000.
Jan. 24	Goods sold to Kavita for ₹ 15,000.
	Trade discount @ 20% is allowed to her.
Jan. 29	Payment received from Kavita by Cheque.

Solution

The above transactions will be entered in the journal as follows :

Journal of Supriya

Date	*Particulars*	*L.F.*	*Dr. Amount ₹*	*Cr. Amount ₹*
2014				
Jan.8	Purchases A/c Dr.		5,000	
	To Sarita A/c			5,000
	(Goods Purchased on credit from Sarita)			
Jan. 12	Neha's A/c Dr.		4,000	
	To Sales A/c			4,000
	(Goods sold on credit to Neha)			

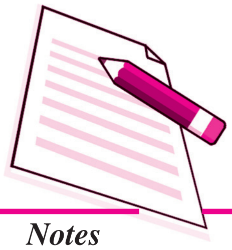
Jan. 18	Bank A/c Dr. Discount A/c Dr. To Neha's A/c (Payment recived from Neha and discount allowed)		3,850 150	 4,000
Jan. 20	Sarita's A/c Dr. To Cash A/c To Discount A/c (Payment made and discount allowed by Sarita)		5,000	 4.900 100
Jan. 22	Purchases A/c Dr. To Cash A/c (Goods purchased for cash)		10,000	 10,000
Jan. 24	Kavita A/c Dr. To Sales A/c (Sold goods to Kavita on credit of ₹ 15000 less Trade Discount @20%)		12,000	 12,000
Jan. 29	Bank A/c Dr. To Kavita's A/c (Payment received from Kavita by Cheque)		12,000	 12,000
	Total		**52,000**	**52,000**

Adjusting Entry

To satisfy the principle of matching cost and revenue, amount of every expense and revenue should pertain to the period for which accounts are being prepared. Thus, there can be two situations : (a) Amount has been received or paid which belongs to more than one accounting year (b) amount of expense or of revenue for the current year stands due and not paid. In the above two cases adjustments need to be made. Any journal entry made to adjust these amounts is called adjusting journal entry.

Journal entries made to adjust for outstanding expenses such as rent outstanding, prepaid expenses such as insurance premium paid in advance, accrued income such as rent (income) has become due but not received and income received in advance such as commission has been received though not yet due are examples of adjusting journal entries.

Following are the items for which adjustment is required :



Notes

1. Outstanding Expenses

An expense for the current accounting peirod should be debited (as increase in expense is to be debited). It is immaterial whether it is paid in that accounting period or not. In case the same expense is not paid during the year, it becomes outstanding for that particular year. It is the liability of the business for that year and, thus, expense outstanding account will be credited, because liabilities are credited for increase.

For example, if salaries are outstanding for ₹ 5,000 for December 2014 then the entry will be made as follows:

2014	Salaries A/c	Dr.	5,000	
Dec.31	To Salaries outstanding A/c			5,000
	(Salaries remaining unpaid for the month of December)			

2. Prepaid Expenses

This is an expense relating to the next year that has been paid in advance during the current year. Thus, in such a case, this amount should not be treated as an expense for this year. It should be treated as an asset in the current year as the services will be received only in the next year (but the payment has been made in this year). As an increase in asset is debited, so prepaid expense account will also be debited.

If, for example, Insurance is prepaid for 2015 in 2014 for ₹ 3,000 then entry will be made as follows:

2014	Prepaid Insurance A/c	Dr.	3,000
Dec. 14	To Insurance Premium A/c		3,000
	(Insurance paid in advance)		

3. Accrued Income

In case, income has been earned but it has not been recieved till now, it is an accrued income. Accrued Income is an asset, as there will be an increase in the asset, it will be debited.

For example, Rent (receivable) is outstanding for the month of November ₹4,000. The entry in such a case will be:

Accrued Rent A/c	Dr.	4,000	
To Rent A/c			4,000
(Being Rent due but not yet received for the period)			

Note : Here Rent Income A/c has been credited for the increase to be made in the amount of Rent for the period of November, which has to be included in the total Rent Income.

4. Income Received in Advance

Whenever Income is received in advance during the current year i.e. it is received for the next year, it should not be included in the current year's income. As this income pertains to the next year, it cannot be treated as income in the current year, so it becomes a liability. As there is an increase in the liability, it should be credited.

For example, if Rent is received in advance for the period January and February 2015 in December 2014, ₹ 9,000. Then the entry will be

Rent A/c	Dr.	9,000	
To Rent Received in Advance A/c			9,000
(Rent received in advance for January and February 2015 in the month of December 2014)			

Note : Here Rent Income A/c has been debited as it has to be decreased by ₹ 9,000 being Rent in advance for January and February 2015 which should not be included in the month of December 2014 as the services have not yet been rendered.

Miscellaneous Entries

(a) Depreciation

Depreciation means decline in the value of an asset due to its wear and tear. It is an expense for the business. Increase in expenses and losses are debited, so depreciation is also to be debited. The value of the asset will also be reduced because of depreciation. As decrease in assets is credited, so the same asset account will be credited.

For example, Depreciation on furniture ₹ 3,000 is charged for the year, Journal entry will be :

Depreciation A/c	Dr.	3,000	
To Furniture A/c			3,000
(Depreciation charged on furniture)			

(b) Interest on Capital

Business may allow interest to its proprietor on his/her capital. It is an expense for the business. As the expense is debited for the increase, interest on capital will be debited. The other account involved here is capital account. As Capital is increasing, it will be credited with the amount of interest on capital.

Notes

Notes

For example, Interest allowed on capital is ₹ 2,500. Thus, the journal entry will be :

Interest on Capital A/c	Dr.	2,500	
To Capital A/c			2,500
(Interest on Capital is allowed)			

(c) Drawings

When the proprietor withdraws some money from the business for his personal or domestic use, it is known as Drawings. Drawings reduce the amount of Capital. As decrease in Capital is debited, drawings will also be debited. As Cash will be decreased as an asset, it will be credited.

For example, Cash withdrawn by the proprietor for his peronal use is ₹ 4,000. So the journal entry will be :

Drawings A/c	Dr.	4,000	
To Cash A/c			4,000
(Drawings made in cash)			

INTEXT QUESTIONS 5.3

I. Fill in the blanks with sutiable word/words:

i. A cominbaiton of two or more simple journal entries is known as ....

ii. Bad debts are .... in the journal, as they are loss to the Business.

iii. In journal, only .... discount is recorded.

iv. No entry is made for .... discount in the Journal.

v. Prepaid Expenses are .... in the journal.

vi. Accrued Income is .... on the journal.

vii. Depreciation reduces the value of an ....

viii. When the proprietor- withdraws money from the business for his personal use, then .... A/c is debited and .... A/c is credited.

II. Complete the following journal entries:

(i) Drawings A/c .... Dr.

To .... A/c

(Money withdrawn from Bank for Personal use)

(ii) Cash A/c .... Dr.

.... Dr.

To Rohit's A/c

(Payment received form Rohit in full and final settlement of his A/c)

(iii) .... A/c Dr.

To Rent A/c

(Rent paid in advance)

(iv) Interest on Capital A/c Dr.

To .... A/c

(Interest allowed on capital)

(v) .... A/c Dr.

To Commission outstanding A/c

(Commission outstanding for December)

(vi) Cash A/c .... Dr.

.... A/c Dr.

To Satish's A/c

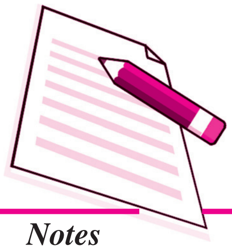
(Part payment of a debt received due to insolvency of Satish)

5.4 CLASSIFICATION OF JOURNAL

Journal is a book in which transactions are recorded in chronological order/ date wise, therefore it will be practically difficult to record if the number of transactions is large. To take the benefit of division of labour, journal should be divided into number of journals.

Journal can be classified into various special journals and Journal proper. Special journals are also known as special purpose books.

Classification of Journal can be explained with the help of the following chart:



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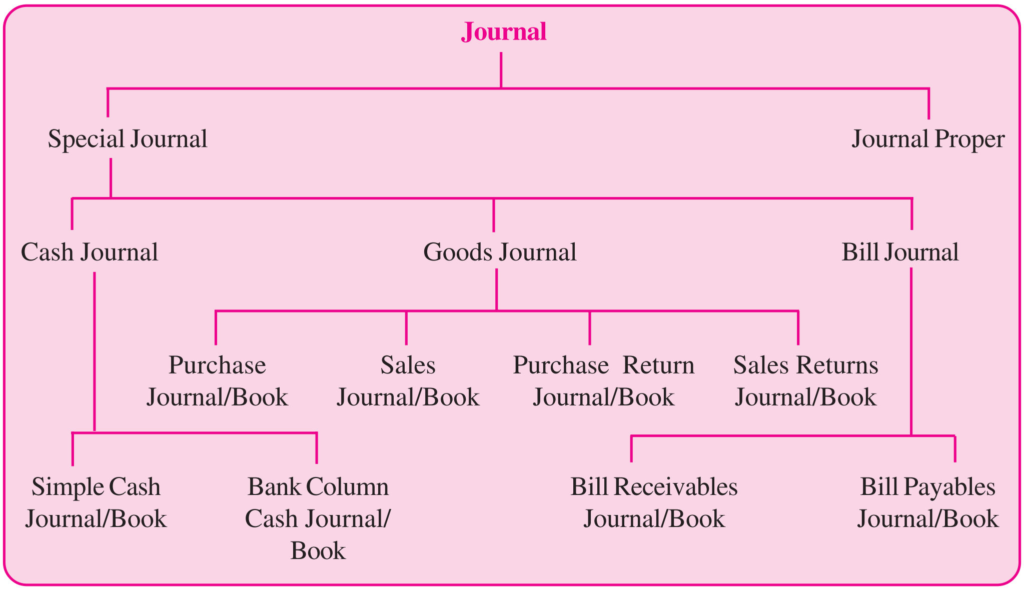


These journals are explained below :

I. Special Journals

Special journals are those journals which are meant for recording all the transactions of a repetitive nature of a particular type. For example, all cash related transactions may be recorded in one book, all credit purchases in another book and so on. These are :

(i) Cash Journal/Cash Book : Cash Journal or Cash Book is meant for recording all cash transactions i.e., all cash-receipts and all cash payments of the 'business. This book helps us to know the balance of Cash in hand at any point of time. It is of two types :

a) **Simple Cash Book :** It records only receipts and payments of cash. It is like an ordinary Cash Account.

b) **Bank Column Cash Book :** This type of Cash Book contains one more column on each side for the Bank transactions. This Book provides additional information about the Bank transactions.

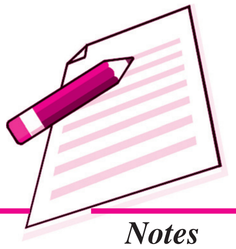
You will learn more details about the Cash Book in the lesson on Cash Book.

ii. Purchases Journal/Purchases Book : This journal is meant for recording all credit purchases of goods only as Cash purchases of goods are recorded in the Cash Book. In this journal, purchases of other things like machinery, typewriter, stationery, etc. are not recorded. Goods means articles meant for trading or the articles in which the business deals.

iii. Sales Journal/Sales Book : This journal is meant for recording all credit sales of goods made by the firm. Cash Sales are recorded in the Cash Book and not

in the Sales Book. Credit Sale of items other than the goods dealt in like sale of old furniture, machinery, etc. are not entered in the Sales Journal.

iv. **Purchase Returns or Returns Outward Journal :** Whenever, the goods are not as per the specifications, the buyer may return these goods to the supplier. These returns are entered in a book known as Purchase Returns Book. It is also known as Returns Outward Journal/Book.



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v. **Sale Returns or Returns Inward Journal :** Sometimes, when the goods are sold to the customer and they are not satisfied with the goods, they may return these goods to the businessman. Such returns are known as Sales Returns. Just like Purchase Returns, they are also recorded in a separate Book which is known as Sales Returns or Returns Inward Journal/Book.

Note : You will learn more details about these Special journals in the subsequent lessons.

vi. **Bill Receivables Journal/Book :** When goods are sold on credit and the date and period of payment is agreed upon between the seller and the buyer, this is duly signed by both the parties. This written document is called a Bill of exchange. For the seller it is a bill receivable and for the buyer it is a bill payable. Bills Receivable Journal/Book and Bills Payable Journal Book are two journals prepared by a businessman. For example : Pranaya sells goods to Gunakshi on credit for ₹5,000 payable after three months. A document is prepared containing these facts and is duly signed by Pranaya and Gunakshi. For Pranaya, it is a Bills Receivable and she will record this transaction in Bill Receivable Book. For Gunakshi, it is a Bill Payable and she will record the transaction in her Bill Payable Book.

vii. **Bill Payable Journal :** This is a journal in which record of those bills is kept on which the firm has given its acceptance for making payments on later dates.

Note : Bill books are not now in practice.

II. Journal Proper

This journal is meant for recording all such transactions for which no special journal has been maintained in the business. Therefore, in this journal, all such transactions are recorded which do not occur frequently and for these transactions, no special journal is required. For example, if Machinery is purchased on credit, it will be recorded in the journal proper, because in the Cash Book, we will record only cash purchases of machinery. Similarly, many other transactions, which do not find their place in the special journals, will be recorded in the Journal Proper such as

(i) Outstanding expenses – Salaries outstanding, Rent outstanding, etc.

(ii) Prepaid expenses – Prepaid Rent, Salaries paid in advance

(iii) Income received in advance – Rent received in advance, interest received in advance, etc.

(iv) Accrued Incomes – Commission yet to be received, interest yet to be received.

(v) Interest on Capital

(vi) Depreciation

(vii) Credit Purchase and Credit Sale of fixed Assets – Machinery, Furniture.

(viii) Bad debts.

(ix) Goods taken by the proprietor for personal use.

INTEXT QUESTIONS 5.6

Fill in the blanks with suitable word/words:

i. Return of goods purchased by the businessman to the suppliers will be entered in ____________ Journal.

ii. In ____________ Journal, credit purchases of assets is not recorded.

iii. When the payment is to be made by the debtor, under a written agreement it is ____________ for him.

iv. An order made by the creditor to his debtor to make the payment on a specified date is known as ____________.

v. In ____________ all such transactions are recorded for which no special journals are maintained.

vi. Assets sold on credit are entered in ____________.

WHAT YOU HAVE LEARNT

- The Book in which all business transactions are recorded, datewise i.e. chronological order is known as Journal.
- A Journal contains the following columns:

  1. Date: 2. Particulars; 3. Ledger folio; 4. Debit Amount; 5. Credit Amount.
- Brief explanation of a journal entry is known as Narration.
- A combination of two or more simple journal entries is known as compound entires.
- Cash discount is recorded in the journal whereas no entry is made for Trade Discount.

- When the amount paid or received is partly utilised by the end of an accounting year, and balance is for services to be provided in the next year or amount is yet to be paid or to be received for the services availed of in the current year, adjustment is required and adjusting entries will be made.
- In big business houses, a journal is classified into various special journals which record transactions of similar and repetitive nature.
- All those transactions which arise occasionally or do not find place in any of the special journals are recorded in Journal proper.
- Special Journals : These are used for recording specific nature transactions:

Cash Book	Purchase Book	Sales Book	Purchase Returns	Sale Returns	Bill Receivable Book	Bill Payable Book

TERMINAL EXERCISE

1. Write the meaning of the following in one sentence each:
   (i) Narration
   (ii) Ledger folio
   (iii) Bad debts
   (iv) Cash Discount
2. The following journal entries have been made by a learner. You are required to make correct entries wherever you think them to be wrong :
   (i) Proprietor brought capital into Business
   Capital A/c .... Dr.
   To Cash A/c
   (ii) Goods Sold for Cash
   Cash A/c .... Dr.
   To Goods A/c
   (iii) Machinery Purchased in Cash
   Purchases A/c .... Dr.
   To Cash A/c

Notes

(iv) Goods sold to Ram for cash

Ram A/c .... Dr.

To Sales A/c

(v) Salary paid to the Accountant

Accountant's personal A/c .... Dr

To Salary A/c

(vi) Rent paid in advance

Prepaid Rent A/c .... Dr

To Cash A/c

3. Distinguish between Special Journals and Journal Proper.

4. Journalise the following transactions :

   (i) Started business with cash ₹ 3,00,000.

   (ii) Bought Goods on credit for ₹ 5,000.

   (iii) Sold Goods for cash ₹ 12,000 and on credit ₹ 8,000.

5. Explain the process of journalising the transactions with suitable examples.

6. What are compound entries? Explain with suitable examples.

7. What are adjusting entries? Give examples of any two such entries.

8. Enter the following transactions in Journal

2014		
Jan. 1	Sushil & Co. started business with cash	1,00,000
Jan. 2	Paid into Bank	60,000
Jan. 4	Purchased Machinery and paid by cheque	30,000
Jan. 6	Bought goods from Naresh	20,000
Jan. 14	Paid salaries	5,000
Jan. 15	Sold goods to Rajesh Kumar	15,000
Jan. 17	Paid for Sundry Expenses	8,500
Jan. 18	Cash deposited into Bank	20,000
Jan. 19	Received Rent	6,000
Jan. 22	Paid Naresh by cheque in full settlement of his A/c	19,750

Jan. 24	Withdrawn cash for personal use	8,000
Jan. 26	Salary paid in advance to Surjeet	2,500
Jan. 28	Rajesh made the payment on A/c	10,000
Jan. 30	Cash Sales for the month	16,500

Notes

9. The following are the transactions of Kumar Swami for the month of January 2014. Journalise these transactions.

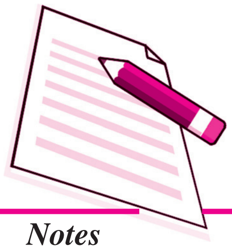
2014

		₹
Jan. 1	Capital paid into Bank	3,00,000
Jan. 1	Bought Stationery for cash	400
Jan. 2	Bought Goods for cash	25,000
Jan. 3	Bought Postage Stamps	600
Jan. 5	Sold Goods for Cash	10,000
Jan. 6	Bought Office Furniture from Mahendra Bros.	40,000
Jan. 11	Sold goods to Jacob	12,000
Jan. 12	Received cheque from Jacob	12,000
Jan. 14	Paid Mahendra Bros. by cheque	40,000
Jan. 16	Sold goods to Ramesh & Co	5,000
Jan. 20	Bought from S. Seth & Bros	15,000
Jan. 23	Bought Goods for cash from S.Narain & Co	22,000
Jan. 24	Sold Goods to P.Prakash	17,000
Jan. 26	Ramesh & Co. Paid on account	2,500
Jan. 28	Paid S.Seth & Bros. by cheque in full settlement	14,800
Jan. 31	Paid Salaries	2,800
Jan. 31	Rent is due to S. Sharma but not yet paid	2,000

ANSWERS TO INTEXT QUESTIONS

5.1 I. Journal is a book of accounts in which all day to day transactions are recorded in the order of their occurence.

II. (i) the journal (ii) original book of entries/Primary Book of entries (iii) entires (iv) narration (v) 'to'



Notes

5.2 I.

S.No.	*Debit* Name of A/c	*Debit* Kind of A/c	*Credit* Name of A/c	*Credit* Kind of A/c
(ii)	Goods A/c	Asset	Creditors A/c	Liability
(iii)	Commission A/c	Expense	Bank A/c	Asset
(iv)	Bank A/c	Asset	Cash A/c	Asset
(v)	Cash A/c	Asset	Interest A/c	Revenue
(vi)	Furniture A/c	Asset	Mukesh A/c	Liability
(vii)	Ramesh A/c	Asset	Goods A/c	Asset

II. (i) Goods sold for cash (ii) Goods purchased from Vinay on credit

III. (i) Goods A/c (ii) Commission A/c (iii) Interest (iv) Cash A/c

5.3 I. (i) Compound entry (ii) Debited (iii) Cash (iv) Trade

(v) Debited (vi) Debited (vii) Asset (viii) Drawings, Cash

II. (i) Cash A/c (ii) Discount (iii) Prepaid Rent
(iv) Capital A/c (v) Commission A/c (vi) Bad Debts A/c

5.4 (i) Purchase Returns - Journal (ii) Purchase Journal

(iii) Bill Payable (iv) Bill of Exchange (v) Journal proper (vi) Journal proper

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6

LEDGER

You have learnt that business transactions are recorded in various special purpose books and journal proper. The accounting process does not stop here. The transactions are recorded in number of books in chronological order. Such recording of business transactions serves little purpose of accounting. Items of same title in different books of accounts need to be brought at one place under one head called an account. There are numerous account titles of items/persons or accounts. All the accounts, if brought in one account book, will be more informative and useful. The account book so maintained is called Ledger.

In this lesson, you will learn about Ledger and posting of items entered in various books of accounts to ledger.

OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning, features and importance of ledger;
- enumerate the various types of ledger;
- state the meaning of posting and explain the steps of posting journal into ledger;
- calculate the balance of the account in the ledger.

6.1 LEDGER : MEANING, IMPORTANCE AND TYPES

You have already learnt about accounts. Each transaction affects two accounts. In each account transactions related to that account are recorded. For example, sale of goods taking place number of times in a year will be put under one Account i.e. Sales Account.

All the accounts identified on the basis of transactions recorded in different journals/ books such as Cash Book, Purchase Book, Sales Book etc. will be opened and maintained in a separate book called Ledger. So a ledger is a book of account; in which all types of accounts relating to assets, liabilities, capital, expenses and revenues are maintained. It is a complete set of accounts of a business enterprise.

> Ledger is bound book with pages consecutively numbered. It may also be a bundle of sheets.

Thus, from the various journals/Books of a business enterprise, all transactions recorded throughout the accounting year are placed in relevant accounts in the ledger through the process of posting of transactions in the ledger. Thus, posting is the process of transfer of entries from Journal/Special Journal Books to ledger.

Features of Ledger

- Ledger is an account book that contains various accounts to which various business transactions of a business enterprise are posted.
- It is a book of final entry because the transactions that are first entered in the journal or special purpose Books are finally posted in the ledger. It is also called the Principal Book of Accounts.
- In the ledger all types of accounts relating to assets, liabilities, capital, revenue and expenses are maintained.
- It is a permanent record of business transactions classified into relevant accounts.
- It is the 'reference book of accounting system and is used to classify and summarise transactions to facilitate the preparation of financial statements.

Format of a Ledger Sheet

The format of a ledger sheet is as follows :

Title of An Account

Dr. Cr.

Date	*Particulars*	*JF*	*Amount* ₹	*Date*	*Particulars*	*JF*	*Amount* ₹

You must have noticed that the format of a ledger sheet is similar to that of the format of an Account about which you have already learnt. A full sheet page may be allotted to one account or two or more accounts may be opened on one sheet. It depends upon the number of items related to that account to be posted.

Importance of Ledger/Utility of Ledger

Ledger is an important book of Account. It contains all the accounts in which all the transactions of a business enterprise are classified. At the end of the accounting period, each account will contain the entire information of all the transactions relating to it. Following are the advantages of ledger.

- **Knowledge of Business Results :** Ledger provides detailed information about revenues and expenses at one place. While finding out business results the revenue and expenses are matched with each other.
- **Knowledge of Book Value of Assets :** Ledger records every asset separately. Hence, you can get the information about the Book value of any asset whenever you need.
- **Useful for Management :** The information given in different ledger accounts will help the management in preparing budgets. It also helps the management in keeping the check on the performance of business it is managing.
- **Knowledge of Financial Position :** Ledger provides information about assets and liabilities of the business. From this we can judge the financial position and health of the business.
- **Instant Information :** The business always need to know what it owes to others and what the others owe to it. The ledger accounts provide this information at a glance through the account receivables and payables.

Types of Ledger

In large scale business organisations, the number of accounts may run into hundreds. It is not always possible for a businessman to accommodate all these accounts in one ledger. They, therefore, maintain more than one ledger.

These ledgers may be as follows :

1. **Assets Ledger :** It contains accounts relating to assets only e.g. Machinery account, Building account, Furniture account, etc.
2. **Liabilities Ledger :** It contains the accounts of various liabilities e.g. Capital (Owner or partner), Loan account, Bank overdraft, etc.
3. **Revenue Ledger :** It contains the revenue accounts e.g.. Sales account, Commission earned account, Rent received account, interest received account, etc.

Notes

4. **Expenses Ledger :** It contains the various accounts of expenses incurred, e.g. Wages account, Rent paid account, Electricity charges account, etc.

5. **Debtors Ledger :** It contains the accounts of the individual trade debtors of the business. Individuals, firms and institutions to whom goods and services are sold on credit by business become the 'trade debtors' of the business.

6. **Creditors Ledger :** It contains the accounts of the individual trade Creditors of the business. Individuals, firms and institutions from whom a business purchases goods and services on credit are called 'trade creditors' of the business.

7. **General Ledger :** It contains all those accounts which are not covered under any of the above types of ledger. For example Landlord A/c, Prepaid insurance A/c etc.

INTEXT QUESTIONS 6.1

I. Fill in the blanks with a suitable word or words :

i. Ledger contains various .... in it.

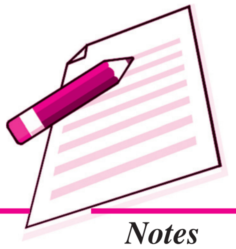
ii. The process of transfer of entries from Journal and special purpose books to ledger is called ....

iii. Ledger is also called ....

iv. Ledger is a .... book of accounting system.

II. Match the column A with column B :

	A		B
i.	Book containing accounts	(a)	Ledger
ii.	Pages number of the ledger	(b)	Liabilities ledger
iii.	Machinery account, Building account, furniture Accounts, etc.	(c)	Revenue ledger
iv.	Loan's account, Bank overdraft account, etc.	(d)	Expenses ledger
v.	Rent paid, wages paid, electricity charges	(e)	Folio
vi.	Sales account, commission account, interest received account etc.	(f)	Assets ledger



6.2 POSTING OF JOURNAL PROPER INTO LEDGER

You know that the purpose of opening an account in the ledger is to bring all related items of this account which might have been recorded in different books of accounts on different dates at one place. The process involved in this exercise is called posting in the ledger. This procedure is adopted for each account.

To take the items from the journal to the relevant account in the ledger is called posting of journal. Following procedure is followed for posting of journal to ledger :

1. Identify both the accounts 'debit' and 'credit' of the journal entry. Open the two accounts in the ledger.
2. Post the item in the first account by writing date in the date column, name of the account to be credited in the particulars column and the amount in the amount column of the 'debit' side of the account.
3. Write the page number of the journal from which the item is taken to the ledger in Folio column and write the page number of the ledger from which account is written in L.F. column of the journal.
4. Now take the second Account and give the similar treatment. Write the date in the 'date' column, name of the account to be debited in the particulars column and the amount in the 'particulars' column of the account on its credit side in the ledger.
5. Write page number of journal in the 'folio' column of the ledger and page number of the ledger in the 'LF' of column of the journal.

Illustration 1

Journalise the following transactions.

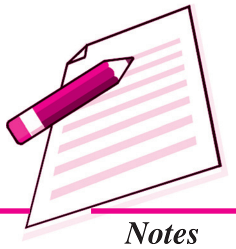
2014		₹
January 1	Commenced business with cash	50,000
January 3	Paid into bank	25,000
January 5	Purchased furniture for cash	5,000
January 8	Purchased goods and paid by cheque	15,000
January 8	Paid for carriage	500
January 14	Purchased Goods from K. Murthy	35,000
January 18	Cash Sales	32,000
January 20	Sold Goods to Ashok on credit	28,000

January 25	Paid cash to K. Murthy in full settlement	34,200
January 28	Cash received from Ashok	20,000
January 31	Paid Rent for the month	2,000
January 31	Withdrew from bank for private use	2,500

Solution :

Journal

Date	*Particulars*	*LF*	*Dr. Amount* ₹	*Cr Amount* ₹
2014				
Jan 1	Cash A/c Dr.		50,000	
	To Capital A/c			50,000
	(Commenced business with cash)			
Jan 3	Bank A/c Dr		25,000	
	To cash A/c			25,000
	(Cash paid into the Bank)			
Jan 5	Furniture A/c Dr		5,000	
	To Cash A/c			5,000
	(Purchased furniture for cash)			
Jan 8	Purchases A/c Dr		15,000	
	To Bank A/c			15,000
	(Purchased goods and paid by cheque)			
Jan 8	Carriage A/c Dr		500	
	To Cash A/c			500
	(Cash paid for carriage charges)			
Jan 14	Purchases A/c Dr		35,000	
	To K. Murthy			35,000
	(Goods purchased on credit)			
Jan 18	Cash A/c Dr		32,000	
	To Sales A/c			32,000
	(Goods sold for cash)			



Notes

Jan 20	Ashok Dr To Sales A/c (Goods sold to Ashok credit)		28,000	 28,000
Jan 25	K Murthy Dr To Cash A/c To Discount A/c (Cash paid to K. Murthi and discount allowed by them)		35,000	 34,200 800
Jan 28	Cash A/c Dr To Ashok (Cash received from Ashok on Account)		20,000	 20,000
Jan 31	Rent A/c Dr To Cash A/c (Cash paid for rent)		2,000	 2,000
Jan 31	Drawings A/c Dr To Bank A/c (Cash withdrawn from bank for domestic use)		2,500	 2,500

INTEXT QUESTIONS 6.2

I. State the meaning of ledger posting :

____

____

II. Following are the steps of posting of journal to ledger but are not in proper order. Write them in correct order :

i. Write the page number of journal in the JF column of ledger and that of ledger on which account has been taken from journal.

ii. Identify the two affected accounts in the journal and open these accounts in the ledger

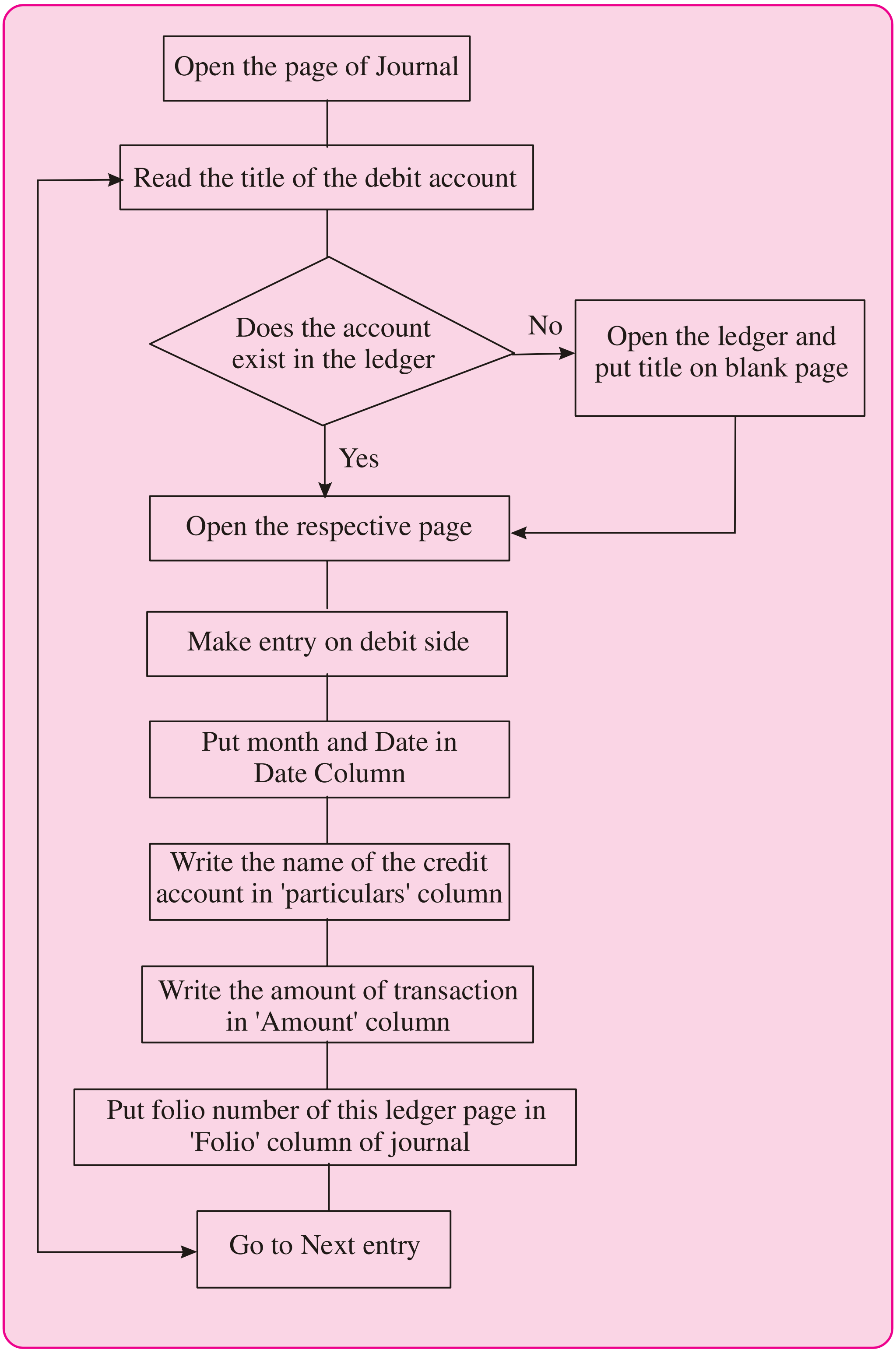
iii. Take date and amount of the debit account, and name of the credit account from journal to ledger in their respective columns.

iv. While posting the credit account from journal in the ledger write page number of the journal from which item is taken to ledger in JF column of ledger and page number of ledger on which item is taken on the LF column of the journal.

Notes

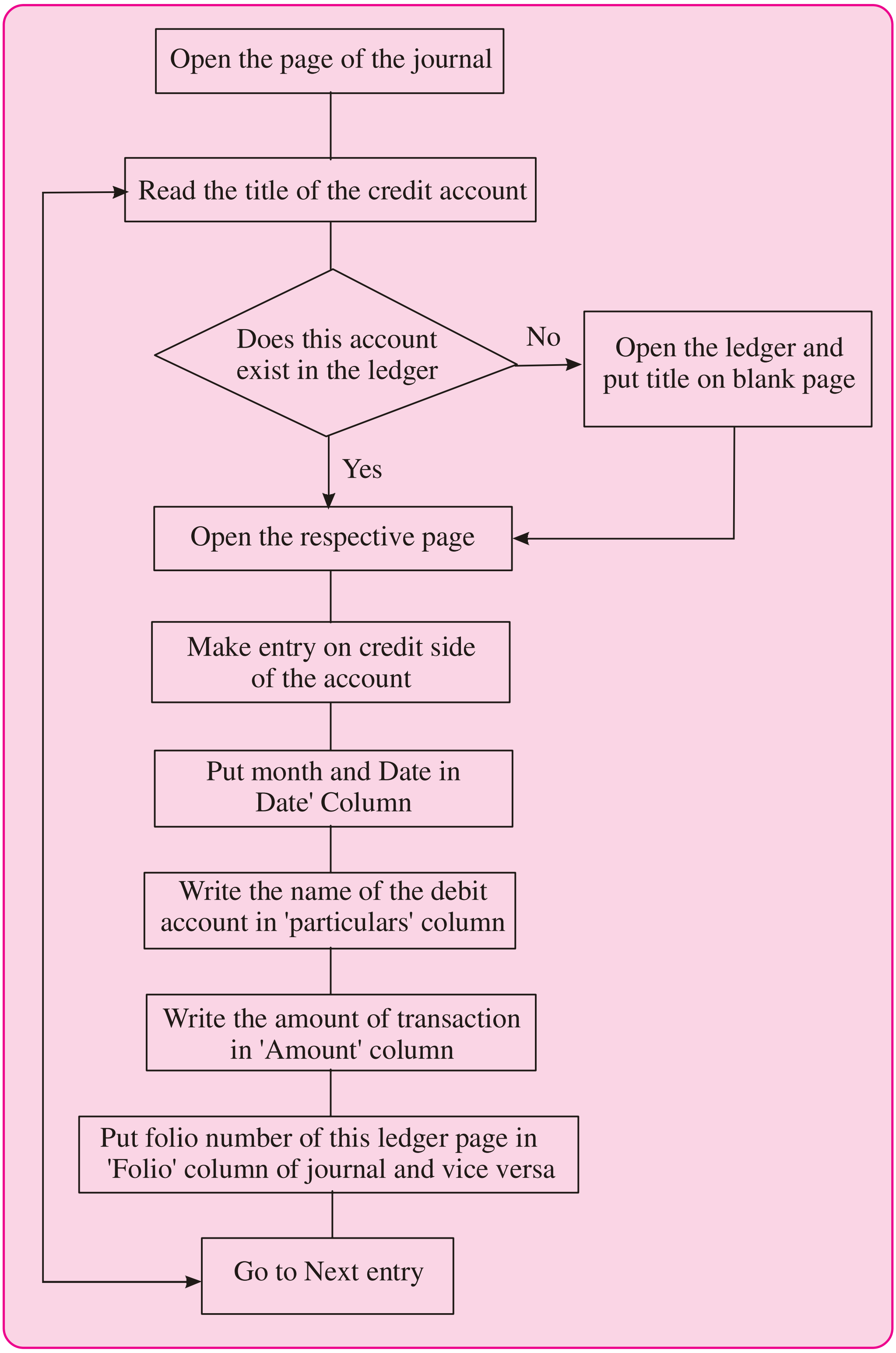
Posting Scheme

Posting from the Journal to the ledger-Dedit Account



Posting Scheme

Posting from the Journal to the ledger-Credit Account



Notes

Notes

6.3 BALANCING OF AN ACCOUNT

Balancing of an account is the process of finding out the difference between the total of debits and total of credits of an account. If debit side total is more than the credit side, the account shows a debit balance. Similarly, the balance will be credit balance if the credit side total of an account is more than the debit side total. This process of ascertaining and writing the balance of each account in the ledger is called balancing of an account. An account has two sides : debit and credit. Items by which this account is debited are entered on its debit side with their amounts and items by which this account is credited are entered on its credit side with their amounts so all items related to an account are shown at one place in the ledger. But then you would like to know the net effect of this account i.e. the balance between its debit amount and credit amount. The following steps are followed in Balancing the Ledger Account :

- Total the two sides of an Account on a rough sheet.
- Determine the difference between the two sides. If the credit side is more than the debit side, the balance calculated is a credit balance.
- Put the difference on the 'Shorter side' of the account such that the totals of the two sides of the account are equal.
- If the difference amount is written on debit side (i.e., if credit. side is bigger) then write as "Balance c/d" (c/d stands for carried down). If difference is written on the credit side (i.e., if debit side is bigger) then write it as "Balance c/d.
- Finally at the end of the year all the ledger accounts are closed by taking out the balance of each account.
- The Balance then should be brought down or carried forward to the next period. If the difference was put on credit side as "Balance c/d" it should now be written on the debit side of the account as "Balance b/d" (b/d stands for brought down) and vice-a-versa. Thus, debit balance will automatically be brought down on the debit side and a credit balance on the credit side.

Balancing of Different Types of Accounts

Assets : All asset accounts are balanced. These accounts always have a debit balance.

Liabilities : All Liability accounts are balanced. All these accounts have a credit balance.

Capital : This account is always balanced and usually has a credit balance.

Notes

Expense and Revenue : These Accounts are not balanced but are simply totalled up. The debit total of Expense/Loss will show the expense/Loss. In the same manner, credit total of Revenue/Income will show increase in income. At the time of preparing the Trial Balance, the totals of these are taken to the Trial Balance.

The Balance of Assets, Liabilities and Capital Accounts will be shown in Balance Sheet whereas total of Expense/Loss and Revenue/Income will be taken to the Trading and Profit and Loss Account. These Accounts are, thus, closed.

If two sides of an Account (usually Assets, Liabilities and Capital) are equal there will be no balance. The Account is then simply closed by totalling up of the two sides of the account.

Illustration 2 : Taking ledger accounts of illustration 1, ledger posting and balancing is as follows :

Solution

Ledger : Cash A/c

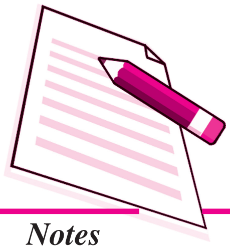
Dr. Cr.

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
Jan 1	Capital A/c		50,000	Jan 3	Bank A/c		25,000
" 18	Sales A/c		32,000	Jan 5	Furniture		5,000
" 28	Ashok		20,000	Jan 8	Carriage		500
				Jan 25	K. Murthi		34,200
				Jan 31	Rent A/c		2,000
				Jan 31	Balance c/d		35,300
			1,02,000				1,02,000
Feb 1	Balance b/d		35,300				

Capital A/c

Dr. Cr.

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
Jan 31	Balance c/d		50000	Jan 1	Cash A/c		50000
			50000				50000
				Feb 1	Balance b/d		50000



Notes

Bank A/c

2014				2014			
Jan 2	Cash A/c		25000	Jan 8	Purchases A/c		15000
				Jan 31	Drawings A/c		2500
				Jan 31	Balance c/d		7500
			25000				25000
Feb 1	Balance b/d		7500				

Furniture A/c

Dr. Cr.

Date	*Particulars*	*JF*	*Amount* ₹	*Date*	*Particulars*	*JF*	*Amount* ₹
2014	Cash A/c		5000	2014	Balance c/d		5000
Jan 1			5000	Jan 31			5000
Feb 1	Balance b/d		5000				

Purchase A/c

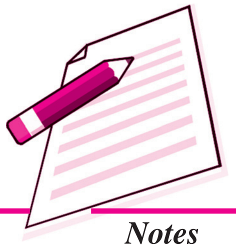
Dr. Cr.

Date	*Particulars*	*JF*	*Amount* ₹	*Date*	*Particulars*	*JF*	*Amount* ₹
2014				2014			
Jan 8	Bank		15,000		Trading A/c		50,000
Jan 14	K. Murthy		35,000				
			50,000				50,000

Carriage A/c

Dr. Cr.

Date	*Particulars*	*JF*	*Amount* ₹	*Date*	*Particulars*	*JF*	*Amount* ₹
2014				2014			
Jan 8	Cash		500		Trading A/c		500
			500				500



Notes

K. Murthy A/c

Dr. Cr.

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
Jan 25	Cash		34,200	Jan 14	Purchases		35,000
Jan 25	Discount		800				
			35,000				35,000

Sales A/c

Dr. Cr.

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
Jan 1	Trading A/c		60,000	Jan 18	Cash		32,000
				Jan 20	Ashok		28,000
			60,000				60,000

Ashok A/c

Dr. Cr.

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
Jan 20	Sales A/c		28,000	Jan 28	Cash		20,000
				Jan 31	Balance c/d		8,000
			28,000				28,000
Feb 1	Balance b/d		8,000				

Rent A/c

Dr. Cr.

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
	Cash A/c		2,000		Profit and Loss A/c		2,000
			2,000				2,000

Notes

Drawing A/c

Dr. Cr.

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
Jan 10	Bank		2,500	Jan 31	Balance c/d		2,500
			2,500				2,500
Feb 1	Balance b/d		2,500				

INTEXT QUESTIONS 6.3

I. Fill in the blanks with suitable word/words :

i. The debit accounts from the journal are entered on the ____________ side of respective account in the ledger.

ii. The ____________ of the account in the ledger should be the same as that is used in the Journal.

iii. The page number of the journal is entered in the ____________ column in the ledger account.

iv. The Figures appearing in the amount column of the ____________ and the amount column of the respective ____________ in the ledger must be the same.

II. Fill in the blanks with suitable word or words :

i. The balance of asset accounts are .... balance.

ii. The balance of liability accounts are always .... balance.

iii. The capital Account generally has .... balance.

iv. The Revenue and expense accounts are closed by taking the balances to ....

WHAT YOU HAVE LEARNT

- Ledger is a register with pages ruled in account form to enable the preparation of accounts.

- Ledger is a permanent record of business transactions which are classified according to various accounts to which they pertain.
- Ledger may be Assets Ledger, Liabilities Ledger, Revenue ledger, Expense ledger, Debtors' ledger, Creditors' ledger and General ledger.
- The debit item of journal is posted to the credit side of the relevant account in the ledger.
- The credit item of journal is posted to the Debit Side of the relevant account in the ledger.
- Name of the account in the journal is entered in 'Particulars' column of the relevant account in the ledger.
- The page No. of journal from where entries are being posted is entered in folio column of the various relevant accounts.
- In the ledger Book, the balances of Assets, Liabilities and Capital are carried forward to the next period. Revenue and Expense accounts are closed by transferring their totals to Trading and Profit and Loss A/c.
- The balance of an account is written on the side having lower total, so that its total becomes equal to the total of the other side.

Notes

TERMINAL EXERCISE

1. What is meant by ledger? Why is ledger prepared?
2. Why is ledger known as the primary book or the principal -book of accounts? Can profit of the business and its financial position be known without maintaining ledger?
3. Enumerate the various types of ledgers which may be maintained by a business.
4. What is the rule for posting the debit account from the journal into the ledger account?
5. What is rule for posting the credit items of the journal into the ledger accounts?
6. What are the advantages of maintaining a ledger?
7. What is meant by balancing of an account? Explain the various steps taken while balancing accounts.
8. How do we balance the following types of accounts?

   (a) Assets (b) expense (c) capital (d) Revenue

9. Following are the transactions of Dhani Ram and Sons for the month of July 2014. Make journal entries, post them into ledger and balance the account.

2014		₹
July 1	Commenced business with cash	60,000
July 2	Paid into bank	40,000
July 5	Purchased furniture for cash	5000
July 7	Purchased Goods and paid for them by cheque	20000
July 10	Sold Goods to Lata Gupta for cash	12000
July 12	Sold Goods to Mahavir on credit	24000
July 18	Purchased Goods from Harish	30000
July 19	Withdrew cash for domestic use	2500
July 20	Received a cheque from Mahavir on account	18900
	Allowed him discount	100
July 27	Paid to Harish cash on account	16800
	Discount allowed by him	200
July 31	Paid salary by cheque	1800
	Paid cash for telephone bill	600

ANSWERS TO INTEXT QUESTIONS

6.1 I. (i) accounts (ii) posting (iii) Principal Book of Account (iv) reference book

II. (i) a (ii) e (iii) f (iv) b (v) d (vi) c

6.2 I. Taking the items from the journal to the relevant account in the ledger is called ledger posting

II. Correct order b, c, a, d

6.3 I. (i) credit (ii) ledger (iii) JF (iv) journal, account

II. (i) debit (ii) credit (iii) credit (iv) Trading and Profit and Loss A/c

ANSWERS TO TERMINAL EXERCISE

9. Total of journal ₹ 2,25,400

ACTIVITY

Contact someone who may be your friend's father or a relative who is in business. He operates his accounts and he collects computerised statements received from the banks. You compare their format with the ledger accounts which you have learnt in your school or the businessman in question are maintaining and find the difference with regards to :

	Traditional A/c	*Computerised A/c*
1. Format of the account		
2. How the accounts are debited/credited		
3. Balancing of accounts		
4. Additional information		

Notes

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7

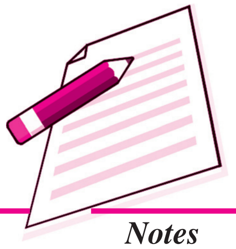
CASH BOOK

A person after passing his/her senior secondary examination started a grocery store. The transactions were limited in number and he/she maintained only one register to record them i.e., Journal. As the business grows, the number of business transactions increases. Recording all the transactions only in the Journal becomes very inconvenient and cumbersome. It needs to be divided into many books. There are various kinds of books that are maintained where the transactions will be recorded in these books according to their nature, such as Cash book for cash transactions, Sales Book for credit sales; Purchases Book for credit Purchases and so on. Out of these books, Cash Book plays a significant role because it records large number of cash items of a business concern. In this lesson you will learn about Cash Book, its meaning and preparation.

OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning of Cash Book;
- enumerate the types of Cash Book;
- state the meaning and draw Simple Cash Book as per format;
- state the meaning and draw Cash Book with Bank Column as per format;
- prepare Simple Cash Book and Cash Book with Bank column;
- posting of Cash Book in the ledger;
- describe the meaning and need of Petty Cash Book;
- prepare the Petty Cash Book.



7.1 CASH BOOK : MEANING AND SIMPLE CASH BOOK

On your birthday you got gift in the form of cash from your parents, grand parents and some of your relatives. In the meantime, you got back some money that you have given to your friend as a loan. You spent this money in buying books and clothes. You went to see movies with your friends. You purchased some toys for your niece. As per habit you noted down all receipts and payments in your note book. At the end of the month, you calculated the balance of cash in hand and tallied it with the actual cash balance with you. You may maintain separate book to record these items of receipts and payments, this book is known as Cash Book.

Cash Book is a Book in which all cash receipts and cash payments are recorded. It is also one of the books of original entry. It starts with the cash or bank balance at the beginning of the period. In case of new business, there is no cash balance to start with. It is prepared by all organisations. When a cash book is maintained, cash transactions are not recorded in the Journal, and no cash or bank account is required to be maintained in the ledger as Cash Book serves the purpose of Cash Account.

Cash Book : Types and Preparation

Cash Books may be of the following Types:

- Simple Cash Book
- Bank Column Cash Book
- Petty Cash Book

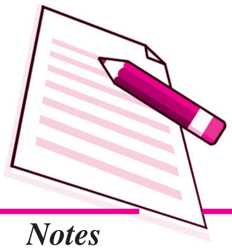
Simple Cash Book

A Simple Cash Book records only cash receipts and cash payments. It has two sides, namely debit and credit. Cash receipts are recorded on the debit side i.e. left hand side and cash payments are recorded on the credit side i.e. right hand side. In this book there is only one amount column on its debit side and on the credit side. The format of a Simple Cash Book is as under:

Format of a Simple Cash Book

Dr Cr

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*



Column-wise explanation is as follows :

Date : In this column Year, Month and Date of transactions are recorded in chronological order.

Particulars : In this column, the name of the account in respect of which cash has been received or payment has been made is written. Account pertaining to the receipts of cash is recorded on the debit side and those pertaining to cash payments on the credit side.

Ledger Folio : In this column, it records the page number of the ledger book on which relevant account is prepared.

Amount : In this column, it records the amount received on debit side and cash paid on its credit side.

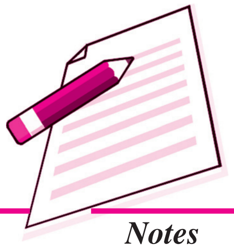
Preparation of Simple Cash Book

Cash Book is in a way, a cash account with debit and credit side and Cash account is an asset account, so the rule followed is 'Increase in assets to be debited and Decrease in asset is to be credited'. This implies that Cash Book is a book where all the receipts in terms of cash are recorded on the debit side of the Cash Book and all the payments in terms of cash are recorded on its credit side. This means:

> Cash Book records all transactions related to receipts and payments in terms of Cash only.

On the debit side in the particulars column, the name of the account, for which cash is received is recorded. Similarly, on the credit side, the name of account for which cash is paid, is recorded. In the amount column the actual cash paid or received is recorded. At the end of the month, cash book is balanced. The cash book is balanced in the same manner an account is balanced in the ledger. The total of the debit side of the cash book is compared with the total of the credit side and the difference, if any, is entered on the credit side of the cash book under the particulars column as 'balance c/d'. In case of Simple Cash Book, the total of debit side is always more than the total of the credit side, since the payment can never exceed the available cash. The difference is written in the amount column and total of the both sides of the cash book becomes equal. The closing balance of the credit side becomes the opening balance for the next period and is written as Balance b/d on the Debit side of the Cash Book for the following period.

Recording of cash transactions in the Simple Cash Book and its balancing is illustrated with the help of the following illustrations :



Notes

Illustration 1

Enter the following transactions in the cash book of M/s. Rohan Traders:

Date	Details	(₹)
2014		
December 01	Cash in Hand	27,500
December 05	Cash received from Nitu	12,000
December 08	Insurance Premium paid	2,000
December 10	Furniture purchased	6,000
December 14	Sold Goods for cash	16,500
December 18	Purchased Goods from Naman for cash	26,000
December 22	Cash paid to Rohini	3,200
December 25	Sold Goods to Kanika for cash	18,700
December 28	Cash Deposited into Bank	5,000
December 30	Rent paid	4,000
December 31	Salary paid	7,000

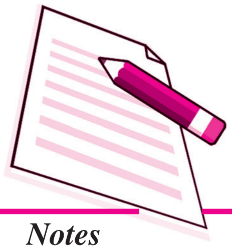
Solution:

Books of M/s. Rohan Traders

Cash Book

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
2014				2014			
Dec.01	Balance b/d		27,500	Dec.08	Insurance premium		2,000
Dec.05	Nitu		12,000	Dec.10	Furniture		6,000
Dec.14	Sales		16,500	Dec.18	Purchases		26,000
Dec.25	Sales		18,700	Dec.22	Rohini		3,200
				Dec.28	Bank A/c		5,000
				Dec.30	Rent		4,000
				Dec.31	Salary		7,000
				Dec.31	Balance c/d		21,500
			74,700				74,700
2015							
Jan. 01	Balance b/d		21,500				



Notes

Illustration 2

Prepare Cash Book for the month of April 2014 from the following particulars :

Date	Details	(₹)
2014		
April 01	Cash in hand	17,600
April 03	Purchased Goods for cash from Rena	7,500
April 06	Sold Goods to Rohan	6,000
April 10	Wages paid in cash	500
April 15	Cash paid to Neena	3,500
April 17	Cash Sales	10,000
April 19	Commission paid	700
April 21	Cash received from Teena	1,500
April 25	Furniture Purchased for cash	1,700
April 28	Rent paid	3,000
April 30	Paid Electricity bill in cash	1,300

Solution:

Cash Book

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014				2014			
Apr. 01	Balance b/d		17,600	Apr. 03	Purchases		7,500
Apr. 17	Sales		10,000	Apr. 10	Wages		500
Apr. 21	Teena		1,500	Apr. 15	Neena		3,500
				Apr. 19	Commission		700
				Apr. 25	Furniture		1,700
				Apr. 28	Rent		3,000
				Apr. 30	Electricity Bill		1,300
				Apr. 30	Balance c/d		10,900
			29,100				29,100
2014							
May 01	Balance b/d		10,900				

Note : Credit transactions are not recorded in cash book (i.e. a credit sales to Rohan ₹ 6,000 on April 6, 2014)

Posting of Cash Book in the Ledger

As we know that cash receipts are shown on debit side of Cash Book and the cash payments are shown on the credit side of Cash Book. Account appearing on the debit side of the Cash Book is posted on the credit side in the relevant ledger. Similarly, account appearing on the credit side of Cash Book is posted on the debit side of the relevant ledger.

Cash Book in itself is a Cash account, so no separate cash account will be maintained in the ledger.

For the posting of various cash book entries in the ledger, refer illustration No. 2.

(a) Posting of Debit side of Cash Book :

Sales Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
				2014 April 17	Cash		10,000

Teena Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
				2014 April 21	Cash		1,500

(b) Posting of credit sides of cash Book

Purchases Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014 April 03	Cash		7,500				

Wages Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014							
April 10	Cash		500				

Neena's Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014							
April 10	Cash		3,500				

Commission Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014							
April 19	Cash		700				

Furniture Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014							
April 25	Cash		1,700				

Rent Account

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014							
April 28	Cash		3,000				

Electricity Bills Account

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
2014							
April 30	Cash		1,300				

INTEXT QUESTIONS 7.1

I. Complete the following sentences with the suitable words:

i. Cash Book starts with the ___________ Balance at the beginning of the period.

ii. When a Cash Book is maintained, cash transactions are not recorded in ___________.

iii. Simple Cash Book records only Cash ___________ and Cash ___________.

iv. The total of ___________ side of the Simple column Cash Book is always more than the total of its ___________ side.

v. Closing Balance of Cash Book becomes the opening balance of next period and is written as ___________.

II. Some transactions are given below. On which side of the Cash Book would you record them. Tick [√] the correct side:

S.No.	Transactions	Debit side	Credit side
i.	Saniya started business with Cash		
ii.	Goods Purchased for cash		
iii.	Goods sold for Cash		
iv.	Cash deposited into Bank		
v.	Rent paid		
vi.	Purchased Computer		
vii.	Closing Cash Balance		
viii.	Cash received from Mohit.		

7.2 BANK COLUMN CASH BOOK

When the number of bank transactions is large in an orgnisation, it is necessary to have a separate book to record bank transactions. Instead of having a separate book to record bank transactions, a column is added on each side of the Simple Cash Book. This type of cash book is known as Bank column Cash Book. All payments into bank are recorded on the debit side and all withdrawals/payments through the bank are recorded on the credit side of the cash book. The format of a Bank column cash Book is as under :

Format of a Bank Column Cash Book

Dr Cr

Date	Particulars	L.F	Cash (₹)	Bank (₹)	Date	Particulars	L.F	Cash (₹)	Bank (₹)

Preparation of Bank Column Cash Book

In Bank column Cash Book, the cash transactions are recorded in a similar manner as are recorded in the Simple cash book. The difference is that Bank column cash book records transactions relating to Bank also. There are some special business transactions which need special treatment in the Bank column of the Cash Book:

(i) Opening balance

(ii) Receipts of cheques

(iii) Contra entries

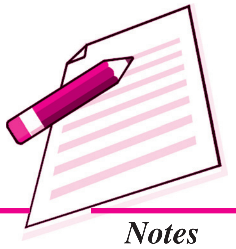
(iv) Endorsement of cheques

(v) Bank charges

The treatment given to these special transactions is as under :

Opening Balance

The opening cash and bank balances are recorded on the debit side of the cash book. Sometimes a businessman withdraws excess amount from the bank (from his bank account) and the closing bank balance of a month is a credit balance. This balance amount is called 'Bank overdraft'. It is written on the credit side of the bank column of the cash book as opening balance. For example, if a business firm has ₹ 12,000 as cash in hand and ₹15,000 as overdraft (credit balance) in the bank, it will be recorded as under:



Notes

Bank Column Cash Book

Dr. Cr.

Date	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*	*Date*	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*
	Balance b/d		12,000			Balance b/d			15,000

Receipt of Cheques

All cash receipts are entered in the cash column and cheques received in the bank column of Cash Book. If the cheques deposited in bank on the same date, it is entered on the debit side of bank column of the cash book. If the cheques received from customer are not deposited in the bank on same day, they are included in cash and written on the debit side in the cash column of cash book. For example: On May 2, 2014 a cheque received from Tarun for ₹ 7,000 and deposited on same date.

Bank Column Cash Book

Dr Cr

Date	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*	*Date*	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*
2014 May 2	Tarun			7,000					

In case, this cheque is deposited on May 10, 2014 the entry on May 02, 2014 is as under:

Bank Column Cash Book

Dr Cr

Date	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*	*Date*	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*
2014 May 2	Tarun		7,000						

Contra Entries

When there is a transaction that relates to both cash and bank, this will be written on one side of Bank Column and on other side of Cash Column, Such transactions are known as 'Contra entries'. In case, cash is withdrawn from bank for office use, it is entered on the credit side of bank column and also in the debit side of cash column of the cash Book. In case, cash is deposited in the bank, the amount is recorded on the

Notes

debit side of bank column and on the credit side of cash column of the cash book. The letter 'C' is written in the LF column on both sides against these entries. These entries are not to be posted into ledger. For example: On May 15, 2014 Cash withdrawn from bank for office use is ₹2,000. In this case the transaction recorded is as under:

Bank Column Cash Book

Dr Cr

Date	Particulars	L.F	Cash (₹)	Bank (₹)	Date	Particulars	L.F	Cash (₹)	Bank (₹)
2014									
May					May				
15	Bank	C	2,000		15	Cash	C		2,000

Endorsement of Cheques

When cheque received from customer is given to some other party i.e. endorsed, on receipt, it is recorded on the debit side of cash column. On endorsement of cheque, the amount is recorded on the credit side of the cash column of Cash Book. For example, on May 22, 2014 a cheque of ₹ 8,000 is received from M/s J.P Traders. On May 27,2014 it was endorsed in favour of M/s Kapila Traders. In this case the transaction recorded is as under:

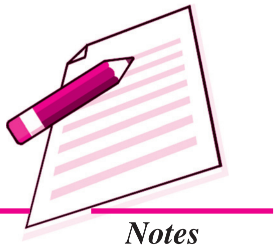
Bank Column Cash Book

Dr Cr

Date	Particulars	L.F	Cash (₹)	Bank (₹)	Date	Particulars	L.F	Cash (₹)	Bank (₹)
2014					2014				
May					May				
22	J.P.Traders (Cheque)		8,000		27	Kapila Traders (Cheque)		8,000	

Bank Charges

If bank charges any interest, outstation cheque collection charges etc., are entered on the credit side of the Bank column of the Cash Book. Similarly, if bank gives interest, collects commission etc., these will be recorded on the debit side on the Bank column of Cash Book.



Notes

Illustration 3

Record the following transactions in the Bank column Cash Book of M/s Time Zone for the month of January 2014.

Date		Details	(₹)
2014			
January	01	Bank Balance	32,500
	01	Cash Balance	12,300
	03	Purchased Goods by cheque	5,300
	08	Goods Sold for cash	9,500
	10	Purchased Typewriter by Cheque	5,400
	15	Sold Goods and received Cheque (deposited on the same day)	7,900
	17	Purchased Stationery by Cheque	1,000
	20	Cash deposited into bank	10,000
	22	Paid Cartage	500
	24	Cheque given to Mudit	7,000
	28	Rent paid by Cheque	3,000
	30	Paid Salary	3,500

Solution

Bank Column Cash Book

Dr | Cr

Date	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*	*Date*	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*
2014					2014				
Jan.1	Balance b/d		12,300	32,500	Jan.3	Purchases			5,300
Jan.8	Sales		9,500		Jan.10	Typewriter			5,400
Jan.15	Sales			7,900	Jan.17	Stationery			1,000
Jan.20	Cash	C		10,000	Jan.20	Bank	C	10,000	
					Jan.22	Cartage		500	
					Jan.24	Mudit			7,000
					Jan.28	Rent			3,000
					Jan.30	Salary		3,500	
					Jan.31	Balance c/d		7,800	28,700
			21,800	50,400				21,800	50,400
Feb 1	Balance b/d		7,800	28,700					

Notes

Illustration 4

Enter following transactions in the Bank column cash Book of M/s Tea Traders for April 2014

Date	Details	Amount (₹)
2014		
April 01	Commenced business with Cash	60,000
April 03	Opened Bank account with SBI	45,000
April 05	Purchased Goods by Cash	7,000
April 10	Purchased Office Machine for cash	5,000
April 15	Sold Goods to Manjula and received cheque	6,000
April 18	Cash Sales	10,000
April 20	Manjula's Cheque deposited into Bank	
April 22	Paid Wages by cheque	300
April 25	Cash withdrawn from Bank for personal use	3,000
April 30	Rent paid by Cheque	2,000

Solution

Bank Column Cash Book

Dr | Cr

Date	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*	*Date*	*Particulars*	*L.F*	*Cash (₹)*	*Bank (₹)*
2014					2014				
Apr. 1	Capital A/c		60,000		Apr. 3	Bank	C	45,000	
Apr. 3	Cash	C		45,000	Apr.5	Purchases		7,000	
Apr. 15	Sales		6,000		Arp.10	Office Machine		5,000	
Apr. 18	Sales		10,000		Apr.20	Bank (Cheque)	C	6,000	
Apr. 20	Cash (cheque)	C		6,000	Apr.22	Wages			300
					Apr.25	Drawings			3,000
					Apr.30	Rent			2,000
					Apr.30	Balance c/d		13,000	45,700
			76,000	51,000				76,000	51,000
May 1	Balance b/d		13,000	45,700					

Illustration 5

Prepare Bank Column Cash Book from the following information for December 2014

Date	Details	(₹)
2014		
Dec 1	Cash in hand	10,500
1	Bank Overdraft	9,500
4	Paid Wages	400
6	Cash Sales	10,000
9	Cash deposited into Bank	5,000
13	Purchased Goods and paid by cheque	6,000
15	Cash deposited into Bank	4,000
18	Paid Trade Expenses by cheque	1,200
22	Rent paid	2,300
25	Received Cash from Rahul	1,500
27	Commission paid	2,000
29	Salary paid	3,500
31	Bought Goods by Cheque	3,000

Solution

Bank Column Cash Book

Dr Cr

Date	Particulars	L.F	Cash (₹)	Bank (₹)	Date	Particulars	L.F	Cash (₹)	Bank (₹)
2014					2014				
Dec 1	Balance b/d		10,500		Dec 1	Balance b/d			9,500
Dec.6	Sales		10,000		Dec.4	Wages		400	
Dec.9	Cash	C		5,000	Dec.9	Bank	C	5,000	
Dec.15	Cash	C		4,000	Dec.13	Purchases			6,000
Dec.25	Rahul		1,500		Dec.15	Bank	C	4,000	
Dec.31	Balance b/d			10,700	Dec.18	Trade Expenses			1,200
					Dec.22	Rent		2,300	
					Dec.27	Commission		2,000	
					Dec.29	Salary		3,500	
					Dec.31	Purchases			3,000
					Dec.31	Balance c/d		4,800	
2015			22,000	19,700	2015			22,000	19,700
Jan 1	Balance b/d		4,800		Jan 1	Balance b/d		–	10,700

Notes

Posting of Bank column Cash book in the Ledger

Like Cash account no separate Bank account will be opened. Account relating to Contra entries on either side of Cash book need not be posted. Other accounts on either side of Bank column of the Cash book will be maintained in the ledger in the same manner which we adopted in the case of Simple cash Book.

For the posting of various cash book items in the ledger refer to illustration No.5.

(a) Posting of Debit side of Bank column Cash Book

Sales Account

Dr. Cr.

Date	*Particulars*	*L.F*	*Amount (₹)*	*Date*	*Particulars*	*L.F*	*Amount (₹)*
				2014 Dec. 6	Cash		10,000

Rahul's Accounts

Dr. Cr.

Date	*Particulars*	*L.F*	*Amount (₹)*	*Date*	*Particulars*	*L.F*	*Amount (₹)*
				2014 Dec. 25	Cash		1,500

(b) Posting of Credit Side of Bank Column Cash Book

Purchases account

Dr. Cr.

Date	*Particulars*	*L.F*	*Amount (₹)*	*Date*	*Particulars*	*L.F*	*Amount (₹)*
2014 Dec.13 Dec.31	 Bank Bank		 6,000 3,000				

Wages Account

Dr. Cr.

Date	*Particulars*	*L.F*	*Amount (₹)*	*Date*	*Particulars*	*L.F*	*Amount (₹)*
2014 Dec. 4	 Cash		 400				

Trade Expenses Account

Dr. Cr.

Date	Particulars	L.F	Amount (₹)	Date	Particulars	L.F	Amount (₹)
2014							
Dec.18	Bank		1,200				

Commission Account

Dr. Cr.

Date	Particulars	L.F	Amount (₹)	Date	Particulars	L.F	Amount (₹)
2014							
Dec. 27	Cash		2,000				

Salary Account

Dr. Cr.

Date	Particulars	L.F	Amount (₹)	Date	Particulars	L.F	Amount (₹)
2014							
Dec.29	Cash		3,500				

Rent Account

Dr. Cr.

Date	Particulars	L.F	Amount (₹)	Date	Particulars	L.F	Amount (₹)
2014							
Dec. 22	Cash		2,300				

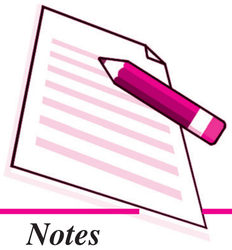
INTEXT QUESTIONS 7.2

Fill in the blanks with suitable word/words:

i. In Bank Column Cash Book ____________ columns are shown on each side.

ii. The Bank column Cash book records transactions relating to ____________ as well as ____________.

iii. Credit balance of Bank Column of Cash Book is called ____________.



Notes

iv. When a cheque is received from a customer but not deposited into the Bank on the same day, it will be recorded on ___________ side in ___________ column.

v. When transactions relate to both cash and bank side of Bank Column Cash Book, Such transactions are known as ___________.

vi. When cheque received from customer is given to some other party it is called ___________.

7.3 PETTY CASH BOOK : MEANING AND NEED

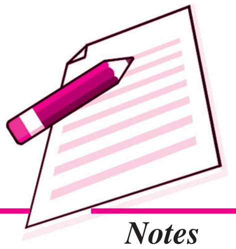
In big business organisations, a large number of repetitive small payments such as, for conveyance, cartage, postage, telegrams, courier and other expenses are made. These organisations appoint an assistant to the Head Cashier. The appointed cashier is known as petty cashier. He makes payments of these expenses and maintains a separate cash book to record these transactions. Such a cash book is called Petty Cash Book. The petty cashier works on the imprest system. Under this system, a definite sum, say ₹ 4000/- is given to the petty cashier at the beginning of the period. This amount is called imprest money. The petty cashier meets all small payments out of this imprest amount, At the end of the period say one month he presents the account to the Head Cashier and gets reimbursed from the Head Cashier. Suppose out of ₹ 4,000 he has spent ₹ 3,850 by the end of the month. He will get ₹ 3,850 from the head cashier. Thus, again he has the full imprest amount in the beginning of the next period. The process of reimbursement can be weekly, fortnightly or monthly depending upon the frequency of small payments. The Petty Cashier is authorised to sanction and disburse small payments. Assignment of the task of making of petty expenses to a person and the maintenance of petty cash book by him reduces the burden of the Head Cashier.

The petty cash book has a number of columns for the amount on the payment side. Each of the amount columns is allotted to items of specific payments, which are common. The last column is allotted for miscellaneous payments. At the end of the period, all amount columns are totalled. The total of the amount paid shown in column 5 is deducted from the column 1. At the opening of the month the total amount paid in the previous month is reimbursed by the Head Cashier.

Format of a Petty Cash Book is given as under:

Petty Cash Book (Format)

Amount Received	*Date*	*Particulars*	*Voucher No,*	*Amount paid (Rs)*	*Analysis of Payments*				
					Postage	*Tele phone Telegram*	*Convey ance*	*Station ery*	*Miscella neous Expenses*
1	2	3	4	5	6	7	8	9	10



Notes

Illustration 6

Mr. Sumit the Petty Cahier of M/s Travels India received ₹ 2,000 on April 1, 2014 from the Head Cashier. Prepare Petty Cash Book on Impress System from the petty payments during the month of April 2014 for the following items:

Date		Details	(₹)
2014			
April	2	Auto fare	200
	3	Courier services	50
	4	Postage stamps	95
	5	Pencils/Pads	65
	6	Speed Post Charges	40
	8	Taxi fare (205+90)	295
	9	Refreshments	310
	11	Auto fare	60
	13	Telegram	64
	16	Computer stationery	165
	19	Bus fare	40
	21	STD Call Charges	205
	23	Refreshment	80
	25	Photostat Charges	45
	28	Courier services	40
	30	Bus fare	40

Solution:

Petty Cash Book

Amount Received	*Date*	*Particulars*	*Voucher No.*	*Amount paid (₹)*	*Analysis of Payments*				
					Postage	*Telephone & Telegram*	*Conveyance*	*Stationery*	*Miscellaneous Expenses*
	2014								
	April								
2,000	01	Cash received							
	02	Auto fare		200			200		

Notes

	03	Courier services		50	50				
	04	Postage stamps		95	95				
	05	Pencils/Pads		65				65	
	06	Speed Post Charges		40	40				
	08	Taxi fare		295			295		
	09	Refreshments		310					310
	11	Auto fare		60			60		
	13	Telegram		64		64			
	16	Computer stationery		165				165	
	19	Bus fare		40			40		
	21	STD Call Charges		205		205			
	23	Refreshment		80					80
	25	Photostat Charges		45					45
	28	Courier services		40	40				
	30	Bus fare		40					
				1,794	225	269	595	230	435
	30	Balance c/d		206					
2,000				2,000					
206	May	Balance b/d							
1,794	01	Cash received							

INTEXT QUESTIONS 7.3

Fill in the blanks with suitable word/words:

i. The assistant of the Head Cashier is known as ....

ii. A separate cash book to record small transactions is called ....

iii. The amount which is paid to the petty cashier at the beginning of a period is known as ....

iv. Under Imprest system of Petty Cash Book, the Petty Cashier is reimbursed with the amount equivalent to what he spent during the ....

Notes

WHAT YOU HAVE LEARNT

- Cash Book is a Book in which all cash receipts and cash payments are recorded. It is also one of the books of original entry.

Type of Cash Book

Simple Cash Book   Bank Column Cash Book   Petty Cash Book

- **Simple Cash Book :** A Simple Cash Book records only cash receipts and cash payments. It has two sides, namely debit and credit.
- **Bank Column Cash Book :** In this type of Cash Book, Bank and Cash columns are shown on each side.
- **Contra Entries :** Transactions that relate to both cash and bank and are entered on cash column of one side and bank column of other side of 'Bank Column Cash Book'. Recording of such transactions is known as 'Contra entries'.
- In big business organisations, a large number of repetitive small payments such as, for conveyance, cartage, postage, telegrams and other expenses are made. These organisations appoint an assistant to the Head Cashier. The so appointed cashier is known as petty cashier. He makes payment of these expenses and maintains a separate cash book to record these transactions. Such a cash book is called Petty Cash Book.

TERMINAL EXERCISE

1. What is Cash Book? Explain the different types of Cash Book.
2. Draw the format of 'Bank Column Cash Book' and write at least five items in it.
3. What is Contra entry? How will you deal with this entry while preparing Bank Column Cash Book?
4. What do you mean by Petty Cash Book ? Explain the imprest system of Petty Cash Book.
5. Enter the following transactions in the Simple Cash Book of M/s Golden Traders:

2014			₹
April	1	Started Business with Cash	30,000

April	2	Goods Purchased for Cash	10,000
April	3	Furniture Purchased	1,000
April	6	Goods Sold for Cash	7,000
April	9	Cartage paid	200
April	10	Postage	100
April	12	Cash Sales	3,000
April	14	Cash withdrawn for Personal use	2,000
April	18	Deposited into Bank	10,000
April	22	Goods purchased for Cash	13,000
April	25	Wages paid	500
April	27	Rent paid	3,000
April	28	Cash Sales	2,000
April	30	Commission received	500

6. From the following transactions prepare Simple Cash Book :

2014			₹
March	01	Cash in hand	32,500
March	08	Cash paid to Rohan	8,000
March	12	Goods Purchased	3,000
March	15	Cash received from Tanaya	2,000
March	18	Cash Sales	4,000
March	22	Paid wages	4,000
March	25	Salary paid	3,000
March	28	Cash paid to Manish	3,500
March	31	Rent paid	2,500

7. Prepare Bank Column Cash Book from the following transactions:

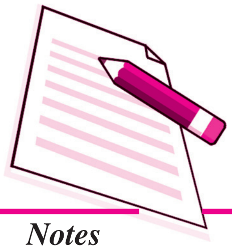
2014			₹
July	1	Cash in hand	18,000
		Cash at Bank	27,500
July	3	Goods sold for cash	10,000

Notes

July	6	Bought Goods by Cheque	16,000
July	8	Cash deposited into Bank	20,000
July	10	Paid Trade Expenses through Cheque	2,000
July	12	Paid Audit Fee for Cash	1,000
July	14	Cheque received from Garima and deposited into bank	4,700
July	18	Withdrew from bank for personal use	2,000
July	20	Purchased office machine by Cheque	5,000
July	22	Wages paid	1,000
July	26	Cash Sales	5,000
July	28	Received Cheque from Mahesh	2,000
July	29	Salary Paid	5,000
July	30	Mahesh's Cheque deposited into Bank	
July	31	Rent paid	2,000

8. Prepare Bank column Cash Book of M/s Style India from the following transactions for the month of April 2014 :

2014			₹
August	1	Cash in hand	18,000
		Cash at Bank	27,500
August	3	Cash Sales	10,000
August	5	Furniture purchased by cheque	8,700
August	8	Paid by cheque to Sonu	13,500
August	12	Received Cheque from Ashima and deposited into Bank	13,000
August	15	Cash Sales	7,000
August	18	Deposited into Bank	8,000
August	20	Withdrawn from Bank for personal use	7,000
August	22	Cheque received from Naveen	7,000
August	24	Rent paid	5,000



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August 26	Naveen's Cheque deposited into Bank	
August 28	Withdrawn from Bank for office use	5,000
August 29	Salary paid	3,000
August 31	Cash paid for Electric Bill	500
August 31	Cash paid for Telephone bill	1,000

9. Prepare Bank Column Cash Book from the following transactions for the month of March 2014 :

2014		₹
March 1	Cash in hand	3,200
	Bank Overdraft	16,500
March 4	Cash Sales	4,000
March 7	Cheque received from Babli	6,000
March 10	Goods Purchased by Cheque	2,000
March 12	Babli's Cheque deposited into Bank	
March 14	Cash Sales	5,000
March 18	Cash deposited into Bank	8,000
March 20	Salary paid	2,000
March 22	Wages paid	150
March 23	Interest charged by Bank	300
March 27	Cash Sales	2,500
March 29	Telephone Bill paid by cash	100
March 31	Purchase of Goods on cash	2,000

10. Prepare Petty Cash Book on imprest system for the month of September 2014 from the following items of petty payments:

2014		₹
Sept. 2	Postage	130
Sept. 4	Stationery	50
Sept. 6	Auto fare	60
Sept. 8	Refreshments	210
Sept. 10	Courier Services	60

Sept.	12	Speed Post Charges	90
Sept.	15	Telegram	20
Sept.	18	Bus fare	30
Sept.	19	Postage	20
Sept.	21	Photostat Charges	30
Sept.	23	Bus fare	20
Sept.	25	STD Call Charges	35
Sept.	27	Taxi fare	110
Sept.	29	Cartage	35
Sept.	30	Computer Stationery	120

The petty cashier received ₹ 1200 from the Head cashier on September 01, 2014.

ANSWERS TO INTEXT QUESTIONS

7.1 I. (i) Cash (ii) Journal (iii) Receipts, Payments

(iv) Debit, Credit (v) Balance b/d

II.

S.No	Debit Side	Credit Side
(i)	√	
(ii)		√
(iii)	√	
(iv)		√
(v)		√
(vi)		√
(vii)		√
(viii)	√	

7.2 (i) Bank/Cash (ii) Cash, Bank (iii) Overdraft
(iv) Debit, Cash (v) Contra entry (vi) endorsement

7.3 (i) petty cashier (ii) petty cash book (iii) Imprest amount

(iv) previous month

Notes

ANSWERS TO TERMINAL EXERCISE

5. Closing Cash in hand ₹ 2,700
6. Closing Cash in hand ₹ 14,500
7. Closing Cash in hand ₹ 4,000, Closing Bank Balance ₹ 29,200
8. Closing Cash in hand ₹ 3,060,Closing Bank Balance ₹ 48,300
9. Closing Cash in hand ₹ 2,550, Bank overdraft ₹ 4,800
10. Closing Cash Balance ₹480

ACTIVITY

If you ask your friends you may come across a friend who gets pocket allowance on regular basis from his prarents and who spends it judiciously and maintains a record of the money spent. He may also be receiving money from his grand parents and/or from grand maternal parents. Procure the note book/diary in which your friend keeps the notes regarding receipts and payments and prepare a Cash Book on the basis of the given information.

320en08

8

SPECIAL PURPOSE BOOKS

In the previous lesson you have learnt that Journal can be divided into different Journals/Books, so that we may get information separately as per the nature of transactions. These journals/books are called Special Purpose Books or subsidiary books. You have already learnt one such special purpose book i.e., Cash Book. In this lesson you will learn other such books like Purchases Book, Purchase Returns Book, Sales Book and Sales Returns Book. A business organisation can divide the journal into many more journals, if the number of transactions of similar nature is quite large.

OBJECTIVES

After studying this lesson, you will be able to :

- state the meaning of Purchases Book and Purchase Returns Book;
- prepare Purchases Book and Purchases Returns Book as per format and its ledger posting;
- state the meaning of Sales Book and Sales Returns Book;
- prepare Sales Book and Sales Returns Book as per format and its ledger posting;
- state the meaning of Bills receivable and bills payable book with its format and
- state the meaning of Journal Proper and its preparation.

8.1 PURCHASES AND PURCHASES RETURNS BOOK

Purchases (journal) book is also a book of original entry. This book records only credit purchases of goods in which the firm deals. Cash purchases of goods are recorded in the cash book. Credit purchases of items not for resale are not recorded in the Purchases Book e.g, If a firm deals in Computer parts, any item of furniture purchased on credit

Notes

is not recorded in this book. These are recorded in another book which is known as 'journal proper'.

In case of Purchase of goods on credit, an Invoice or Bill prepared by the supplier is received. It contains information about the date of transaction, details of items purchased at List Price less trade discount, if any, Invoice Number, and the net amount payable. Trade discount and other details of invoice need not be recorded in this book. Format of Purchases Book is as under:

Purchases (Journal) Book

Date	*Invoice No.*	*Name of supplier*	*L.F.*	*Details*	*Amount (₹)*

Column-wise explanation is as follows :

Date : In this column Year, Month and Date of transactions are recorded in chronological order.

Invoice Number : In this column, Invoice number is entered.

Name of Supplier : In this column, the name of the supplier from whom the goods were purchased is written.

Ledger Folio : In this column, it records the page number of the ledger book in which suppliers account is maintained.

Detail : The amount in respect of each article is written in this column. If the seller has allowed a Trade Discount it is also deducted in this column itself.

Amount : In this column, it records the net amount payable to the supplier.

Illustration 1

Record the following transactions for the Month of August 2014 in the Purchases Book of M/s Harsha Electronics :

Date	Details
2014	Purchased from M/s.Naresh Electronics (Invoice No. 250)
August 5	5 Colour T.V @ ₹ 12500 per piece.
	Trade Discount on all items @20%.

Notes

August 10 Bought from M/s Capital Electronics: (Invoice No. 826)
20 Tape Recorders @ ₹ 1650 per piece
Trade Discount 10% on purchases.

August 17 Purchased from M/s. East Electronics: (Invoice No. 456)
15 Stereos @ ₹ 4000 per piece
2 Color T.V. 14″ @ ₹ 10500 per piece
Trade Discount @5%.

August 25 Purchased form M/s. Naresh Electronics: (Invoice No. 294)
10 Small T.V. @ ₹ 1,200 per piece
3 Colour T.V. 17″ @ ₹ 12000 per piece
Trade Discount 10%.

August 30 Bought from M/s Pavitra Electronics: (Invoice No. 82)
20 Video cassettes @ ₹ 150 per piece Net.

Solution:

Books of M/s Harsha Electronics
Purchases (Journal) Book

Date	*Invoice No.*	*Name of supplier*	*L.F.*	*Detail*	*Amount (₹)*
2014					
August 5	250	**Naresh Electronics**		5 x 12,500 = 62,500	
		5 Clr. TV. @ 12,500		(-) 20% Discount = 12,500	50,000
August 10	826	**Capital Electronics**		20 x 1,650 = 33,000	
		20 Tap rec. @ 1,650		(-)10% Discount = 3,300	29,700
August 17	456	**East Electronics**		15 x 4,000 = 60,000	
		15 Steros @ 4,000		2 x 10,500 = 21,000	
		20 Clr. T.V @ 10,500		81,000	
				(-) 5% Discount = 4,050	76,950
August 25	294	**Naresh Electronics**		10 x 1,200 = 12,000	
		10 Small T.V. @ 1,200		3 x 12,000 = 36,000	
		3 Clr. T.V @ 12,000		48,000	
				(-) 10% Discount = 48,00	43,200
August 30	82	**Pavitra Electronics**		20 x 150	3,000
		20 Video Cas. @ 150			2,02,850

Notes

Posting of Purchases Journal/Book into Ledger

Posting from the Purchases Journal/Book is done daily to relevant supplier's accounts on the credit side with the Invoice amount at the end of the month, the grand total of the Purchases Journal/Book is posted to the Debit side of Purchases Account in the ledger, and written in the Particulars column "Sundries as per Purchases Book".

For the posting of Purchase Journal/ Book items into the ledger refer to Illustration No. 1.

Books of M/s Harsha Electronics

M/s. Naresh Electronics

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
				2014			
				Aug.05	Purchases		50,000
				Aug.25	Purchases		43,200

M/s. Capital Electronics

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
				2014			
				Aug.10	Purchases		29,700

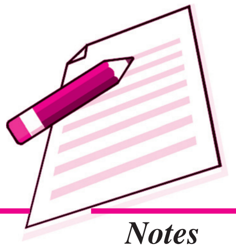
M/s.East Electronics

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
				2014			
				Aug.17	Purchases		76,950

M/s.Pavitra Electronics

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
				2014			
				Aug.30	Purchases		3,000


Notes

Purchases Account

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
2006							
Aug.31	Sundries as per Purchases Book		2,02,850				

Purchase Returns Journal

Return of goods purchased is recorded in this book. Sometimes goods purchased from the supplier are returned for various reasons such as goods are not as per our order, or are defective. These goods are returned to the supplier. For this purpose a debit note is prepared and sent to the supplier for making necessary entries. The record of such return of goods in a journal is called Purchase Returns journal, the format of which is as under :

Purchase Return (Journal) Book

Date	*Debit Note No.*	*Name of supplier*	*L.F.*	*Deatil*	*Amount (₹)*

Column-wise explanation is as follows :

Date : In this column, Year, Month and Date of transactions are recorded in chronological order.

Debit Note Number : In this column, the debit note number is written.

Name of Supplier : In this column, the Name of the supplier from whom the goods were purchased is written.

Ledger Folio : In this column, the page number of the ledger book on which supplier account is prepared is recorded.

Deatil : In this column the details of the goods returned to the supplier is recorded.

Amount : In this column, it records the amount of the total goods returned to the supplier.

Illustration 2

The Details submitted by M/s. Harsha Electronics for the month of August 2014 are as under :

Date	Details
2014	Goods returned to M/s. Capital Electronics vide Debit note
August 17	No.016/2014
	5 Tape Recorders @ ₹1650 per piece
	Trade Discount @ 10% on purchases.

Solution

Books of M/s Harsha Electronics
Purchases Returns (Journal) Book

Date	*Debit Note No.*	*Name of supplier*	*L.F.*	*Detail*	*Amount (₹)*
2014					
Aug. 17	016	Capital Electronics		5 x 1,650 = 8,250	
		5 Tape Recorders @ 1,650		(-) 10% Discount = 825	7,425
					7,425

Posting of Purchase Returns Journal/Book into Ledger

The monthly total of Purchase Returns Journal/Book is credited to the Purchase Return account in the ledger. Supplier account to whom the goods are returned is debited with the net amount of goods returned.

For the posting of Purchase Returns Journal/Book into the ledger refer Illustration No.2.

Solution

M/s.Capital Electronics

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014							
Aug. 17	Purchase Returns		7,425				

Purchases Returns Account

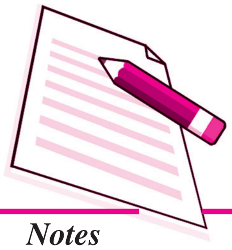
Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
				2014			
				Aug.31	Sundries as Per Purchase returns Book		7,425

Illustration 3

Enter the following transactions in the Special Journal/Books of M/s Mohit Stationery Mart of June 2014, prepare Purchases Book and Purchase Returns Book.

Date 2014	Details
June 0l	Purchased from M/s.Seema Stationers as per Invoice No. 031
	50 Paper Rim @ ₹ 100 Per Rim.
	60 Simple Books @ ₹ 20 Each
	100 Pkt Pencils @ ₹ 50 Per Pkt.
June 12	Bought from M/s Nisha Paper Mart as per Invoice No. 1202
	200 Files @ ₹ l2 per file
	Trade Discount @ 5% on purchases.
June 22	Purchased from M/s. Bansal Stationers as per Invoice No. 3211
	500 Drawing Paper @ ₹ 4 each
	100 Pkt Pencil Color @ ₹ 20 per pkt.
	Trade Discount 5%.
June 23	Goods Returned to M/s Nisha paper Mart as per Debit Note No. 002
	50 Files @ ₹ 12 each
	Trade Discount 5%.
June 24	Purchased from M/s. Stationery Zone as per Invoice No. 6783
	200 pkt Pens @ ₹ 100 per pkt.
	Trade Discount 10%
June 27	Purchased form M/s. Sumit Paper Mart as per Invoice No. 2340
	100 pkt water Color @ ₹ 50 per pkt.
	50 pkt Paint Brushes @ ₹ 40 per pkt.
	Trade Discount 10%
June 28	Goods Returned to M/s Bansal Stationers as per Debit Note No. 042
	50 Pkt Pencil Color @ ₹ 20 per pkt.
	Trade Discount 5%.
June 30	Bought from M/s Handa File Trader as per Invoice No. 1321
	200 Plastic Files @ ₹ 25 per file
	Trade Discount 10%



Notes

Solution:

Books of M/s Mohit Stationery Mart
Purchase (Journal) Book

Date	*Invoice No.*	*Name of supplier*	*L.F.*	*Details (₹)*	*Amount*
2014					
June 01	031	**Seema Stationers**			
		50 Paper Rim @ 100		50 x 100 = 5,000	
		60 Sim. Books @ 20		60 x 20 = 1,200	
		100 Pkt. Pencil @ 50		100 x 50 = 5,000	11,200
June 12	1202	**Nisha Paper Mart**			
		200 files @ 12		200 x 12 = 2,400	
				(-) 5% Discount = 120	2,280
June 22	3211	**Bansal Stationers**			
		500 Draw. Paper @ 4		500 x 4 = 2,000	
		100 Pkt. Pencil @ 20		100 x 20 = 2,000	
				4,000	
				(-)Trade Disc. 5% = 200	3,800
June 24	6783	**Stationery Zone**			
		200 Pkt. Pens @ 100		200 x 100 = 20,000	
				(-) Trade Disc. 10% = 2,000	18,000
June 27	2340	**Sumit Paper Mart**			
		100 Pkt. Water Clr. @ 50		100 x 50 = 5,000	
		50 Pkt Paint Brush @ 40		50 x 40 = 2,000	
				7,000	
				(-) Trade Disc. 10% = 700	6,300
June 30	1321	**Handa File Trader**			
		200 Plastic Files @ 25		200 x 25 = 5000	
				(-) Trade Disc. 10% = 500	4,500
					46,080

Purchase Returns (Journal) Book

Date	*Debit Note No.*	*Name of supplier*	*L.F.*	*Details (₹)*	*Amount*
2014					
June 22	002	**Nisha Paper Mart**		50 x 12 = 600	
		50 fiels @ 12		(-) Trade Disc. 5% = 30	570
June 28	042	**Bansal Stationers**		50 x 20 = 1000	
		50 Pkt. Pencil Clr. @ 20		(-) Trade Disc. 5% = 50	950
					1,525

Notes

INTEXT QUESTIONS 8.1

Which of the following transactions will be entered in the Purchases Book or Purchase Returns Book? If the transaction is not to be entered in any of the two write None of these.

i. Furniture purchased from M/s. Modern Furnishers.

ii. Goods purchased from M/s Sell Well were returned to them as goods were not according to the specifications.

iii. Goods of ₹ 6,000 were purchased from M/s Rohit Brothers for Cash.

iv. M/s. Ravi & Sons supplied goods on Credit.

v. Purchased goods from Himanshu on Credit.

8.2 SALES JOURNAL/BOOK AND SALES RETURNS JOURNAL

Transactions relating to Sale of goods on credit are recorded in the Sales Journal. Cash sales are recorded in the Cash Book. It means that Sales Journal records only credit sales of goods. For example sale of old furniture by a firm which is dealing in computers is not treated as goods and items relating to computer are regarded as goods.

In case of sale of goods on credit, one copy of an Invoice or Bill prepared by the vendor firm is given to the customer. It contains information about the date of transaction, details of items sold at List Price less trade discount if any. Invoice Number and the amount receivable or payable by customer.

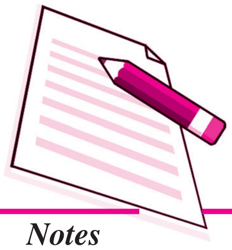
When a customer purchases goods in bulk, the vendor may allow him a discount, which is called trade discount. In the invoice, trade discount is deducted from the list price of the goods and the customer is debited only with the net amount. This discount is quite different from the cash discount, which is allowed for payment within a stipulated period. The format of the Sales Journal/Book is given as under :

Sales (Journal) Book

Date	*Invoice No.*	*Name of customer*	*L.F.*	*Details*	*Amount (₹)*

Column-wise explanation is as follows :

Date : In this column Year, Month and Date of transactions are recorded in chronological order.



Notes

Invoice No. : In this column, Invoice number is written.

Name of Customer : In this column, Name of the Customer is recorded.

L.F. : In this Column, page number of the ledger book in which debtor's account is maintained.

Detail : For each item the amount is recorded in the detail column, after totalling the amount of sale to one customer, charges for packing etc., are added and the trade discount, if any is deducted.

Amount : In this column, the amount of the total goods sold to the customer is recorded.

Illustration 4

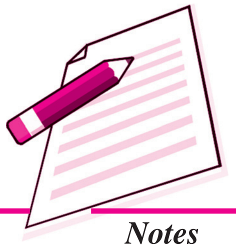
M/s Furniture Mart wants you to prepare Sales journal for the month ended March 2014, from the following details of sale of goods :

Date	Details
2014	
March 4	Sold on Credit to M/s Mena Traders : Vide Invoice No.213 (a) Two Double Beds @ ₹ 7,100 each. (b) Five Chairs @ ₹ 260 each
March 9	Sold on Credit to M/s Kohli Furniture : Vide Invoice No. 278 5 Tables @ ₹ 1,400 Each
March 24	Sold on Credit to M/s Handa Furniture Mart : Vide Invoice No. 302 4 Sofa Sets @ ₹ 18,000 each
March 30	Sold on Credit to M/s Furniture Traders : Vide Invoice No. 327, 6 Single Beds @ ₹ 6,000 each

Solution:

Books of M/s Furniture Mart
Sales (Journal) Book

Date	*Invoice No.*	*Name of customer*	*L.F.*	*Details*	*Amount (₹)*
2014					
March 4	213	**Mena Traders**			
		2 Double Bed @ 7,100		2 x 7,100 = 14,200	
		5 Chairs @ 260		5 x 260 = 1,300	15,500
March 9	278	**Kohli Furniture**			
		5 Tables @ 1,400		5 x 1,400	7,000
March 24	302	**Handa Furniture Mart**			
		4 Sofa Sets @ 18,000		4 x 18,000	72,000



Notes

March 30	327	**Furniture Traders** 6 Single Beds @ 6,000		6 x 6,000	36,000
					1,30,500

Posting of Sales Journal/Book into Ledger

The monthly total of the Sales Book is posted to the credit side of the Sales account in the ledger. The net amount due from each customer is debited to customer account individually. The customer's account is generally posted daily. For the posting of Sales Journal/Book into the ledger refer to Illustration No. 4.

Books of M/s Furniture Mart

M/s. Mena Traders

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014 March 4	Sales		15,500				

M/s. Kohli Furniture

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014 March 9	Sales		7,000				

M/s. Handa Furniture Mart

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014 March 24	Sales		72,000				

M/s. Furniture Traders

Dr. Cr.

Date	*Particulars*	*L.F.*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
2014 March 30	Sales		36,000				

Sales Account

Dr. Cr.

Date	*Particulars*	*L.F*	*Amount (₹)*	*Date*	*Particulars*	*L.F.*	*Amount (₹)*
				2014 Mar. 31	Sundries as per Sales Book		1,30,500

Notes

Sales Returns Journal/Book

Goods returned by the customers are recorded in the Sales returns journal/book. The Sales returns Book does not record the return of goods sold on cash basis. Goods supplied to the customer (Debtors) may not be as per specifications of the order, or some of the goods may get damaged during transit. The Customer returns these goods. For this purpose a credit note is made in favour of the customer. The format of Sales returns Book is as under :

Sales Return (Journal) Book

Date	*Credit Note No.*	*Name of customer*	*L.F.*	*Detail*	*Amount (₹)*

Column-wise explanation is as follows :

Date : In this column, Year, Month and Date of transactions are recorded in chronological order.

Credit Note No. : In this column, the Credit note number is written.

Name of Customer : In this column, the Name of the customer is written.

Ledger Folio : In this column, it records the page number of the ledger book on which customer account is prepared.

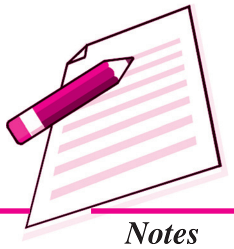
Detail : For each item the amount is recorded in the detail column, after totalling the amount for the goods received from customer and deducting the amount of discount allowed at the time of sale.

Amount : In this column, it records the amount of the total goods returned from customer.

Illustration 5

The Details submitted by M/s Furniture Mart for the month of March 2014 are as under :

Date	Details
2014	Returns from M/s Kohli Furniture : 2 Tables @ ₹ 1,400 Each
March 18	Vide Credit Note No. 019



Notes

Solution:

Books of M/s Furniture Mart
Sales Returns (Journal) Book

Date	Debit Note No.	Name of supplier	L.F.	Detail	Amount (₹)
2014					
March 18	019	**Kohli Furniture**			
		2 Tables @ ₹ 1,400		2 x 1400	2,800
					2,800

Posting of Sales Returns Journal/Book into Ledger

The total of the Sales Returns Journal/Book is debited to the Sales Returns account in the ledger. Each customer account from whom the goods are returned is credited with the net amount of the returns.

For the posting of Sales Journal/Book into the ledger refer to illustration No.5.

Solution :

Books of M/s Furniture Mart
M/s. Kohli Furniture

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
				2014			
				Mar. 18	Sales Returns		2,800

Sales Return Account

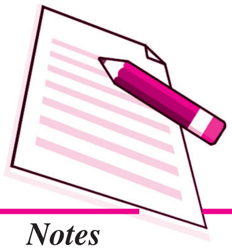
Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
2014							
Mar. 31	Sundries as per Sales Returns Book		2,800				

Illustration 6

Enter the following transactions in Special Purpose Book of M/s Goel Electronic for the month of August 2015

Date	Details
2015	
August 4	Sold on Credit to M/s.Tanaya Electronics as per Invoice No. 1248 12 Set [6"] B.W. T.V. @ ₹ 900 per set. 5 set DVD Players @ ₹ 2,500 per set Less trade Discount 5%



Notes

August 10 Sold on Credit to M/s Kanshik Electronics as per Invoice No. 1278
5 Washing Machines @ ₹ 4,500 Per Machine
2 Color T.V. 29" @ ₹ 16,500 Per T.V.
Less 10% Trade Discount

August 12 M/s.Tanaya Electronics returned goods as per credit Note No.73
1 Set DVD Player @ ₹ 2,500 per set
1 Set [6"] BW T.V. @ ₹ 900 per set.
Trade Discount allowed @ 5%

August 18 Sold on Credit to M/s Diamond Electronic as per Invoice No. 1290
5 Tape Recorders @ ₹ 1,000 each
10 Two-in One @ ₹ 1,800 each
Less Trade Discount 5%

August 25 Sold on Credit to M/s Electronic Zone as per Invoice No. 1299
5 Water cooling Machines @ ₹ 7,000 each

August 28 Sold on Credit to M/s North East Electronics as per Invoice No. 1308
10 Music Systems @ ₹ 3,000 each
Less Trade Discount 10%

August 31 M/s. Electronic Zone returned goods as per credit Note No.93
1 Water cooling Machine @ ₹ 7,000 each

Solution

Books of M/s Goel Electronic
Sales (Journal) Book

Date	*Invoice No.*	*Name of customer*	*L.F.*	*Detial*	*Amount (₹)*
2015					
August 4	1248	**Tanaya Electronics**			
		12 T.V. @ 900		12 x 900 = 10,800	
		5 DVD @ 2,500		5 x 2,500 = 12,500	
				23,300	
				(-)5% T. Disc. = 1,165	22,135
August 10	1278	**Kanshik Electronics**			
		5 W. Machine @ 4,500		5 x 4,500 = 22,500	
		2 Clr. T.V. @ 16,500		2 x 16,500 = 33,000	
				55,500	
				(-)10% T.Disc = 5,550	49,950

Notes

August 18	1290	**Diamond Electronics**			
		5 Tape Rec. @ 1,000		5 x 1,000 = 5,000	
		10 Two in One @ 1,800		10 x 1,800 = 18,000	
				23,000	
				(-)5% T. Disct.= 1,150	21,850
August 25	1299	**Electronic Zone**			
		5 Water Cooling			
		Machine @ 7,000		5 x 7,000	35,000
August 28	1308	**North East Electronics**			
		10 Music System @ 3,000		10 x 3,000 = 30,000	
				(-) T. Disc. 10% = 3,000	27,000
				Total	1,55,935

Books of M/s Goel Electronic
Sales Returns (Journal) Book

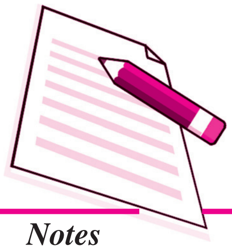
Date	*Debit Note No.*	*Name of supplier*	*L.F.*	*Detail*	*Amount (₹)*
2015					
August 12	73	**Tanaya Electronics**			
		1 DVD Player @ 2,500		1 x 2500 = 2,500	
		1 T.V. @ 900		1 x 9 = 900	
				3,400	
				(-)5% T. Disc. = 170	3,230
August 31	93	**Electronic Zone**			
		1 Water Cooling			
		Machines @ 7,000		1 x 7,000	7,000
				Total	10,230

8.3 BILLS RECEIVABLE BOOK AND BILLS PAYABLE BOOK

Any enterprise which will accept/draw a number of bills will record these transactions in special subsidiary books. Bills receivable are recorded in the Bills Receivable Book. Bills payable are recorded in the Bills payable book.

Bills Receivable Book

Like Purchases Book, where all credit purchases of goods are firstly recorded, the Bills Receivable Book is maintained for recording the receipts of all bills of exchange. Bills Receivable Book is maintained, where the number of bill transactions



Notes

is sufficiently large. Each bill received is posted only in the credit side of the party's account from the bills receivable book. At the end of the period, the amount of bills received as per the bills receivable book, is debited in the bills receivable account in the ledger.

Usual Format of Bill Receivable Books is given below :

Bills Receivable Book

S. No.	*Date of Receipt*	*From whom received*	*Name of Acceptor*	*Date of Bill Drawn*	*Term*	*Date of Maturity*	*Where Payable*	*Amount (₹)*	*How Disposed*

Ledger Posting of Bills Receivable Book

1. At the end of a month, total amount of Bills Receivable book is debited to the Bills Receivable Account by writing, 'To sundries as per the Bills receivable book'.
2. The debtors or customers account is credited by writing 'By Bills Receivable Account'.

Illustration 7

A received the following Bills of Exchange. Record them in Bills Receivable Book and post them into the Ledger:

2014

Jan. 1 Drawn on Raman a Bill of Exchange at 3 months which was accepted and returned by him on January 1, 2014. The amount of the bill is ₹ 10,000.

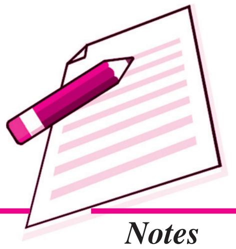
Jan. 10 Drawn on Savita a Bill of Exchange for ₹ 5,000 at 2 months, which was accepted on the same day. The bill is payable at Punjab National Bank.

Jan. 12 Raman's acceptance endorsed in favour of Hari Kumar in full settlement of a debt of ₹ 10,250.

Solution :

Bills Receivable Book

S. No.	*From whom received*	*Name of Acceptor*	*Date of Bill*	*Term*	*Date of Maturity*	*Amount (₹)*	*How Disposed*
			2014				
	Raman	Raman	Jan. 1	3 months	April 4	10,000	Endorsed to
	Savita	Savita	Jan. 10	2 months	March 14	5,000	Hari Kumar
						15,000	



Notes

Dr. **Bills Receivable Accounts** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2014							
Jan. 31	To Sundries as per B/R Book		15,000				

Dr. **Raman** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2014			
				Jan. 1	By Bills Receivable A/c		10,000

Dr. **Savita** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2014			
				Jan. 10	By Bills Receivable A/c		5,000

Bills Payable Book

It is a special journal for recording the acceptance of the bills drawn by the creditors. Each Bill payable is entered in this book and from here it is posted to the debit side of creditor's account. The total amount of bills payable for the period is credited in the Bills Payable Account.

Usual Format of Bills Payable Book is given below :

Bills Payable Book

S. No.	Date of issue	To whom given	Payee	Term	Date of Maturity	Where payable	Amount ₹	Remarks

Ledger Posting of Bills Payable Book.

1. The amount column of the Bills Payable Book is totalled and credited to the Bills payable account by writing 'By sundries as per Bills Payable Book.'
2. The creditor's or seller's account is debited writing 'To Bills Payable Account'.

Illustration 8

A accepted the following bills. Enter them in Bills Payable Book and post them into the Ledger :

Notes

2013

April 10 Accepted Vivek's bill for ₹ 20,000 due at 2 months.

April 24 Accepted the bill drawn by Chunnu for ₹10,000 at 1 month payable at Punjab National Bank.

Solution

Bills Payable Book

S. No.	*Date of issue*	*To whom given*	*Payee*	*Term*	*Date of Maturity*	*Where payable*	*Amount ₹*	*Remarks*
	2013							
1.	April 10	Vivek	Vivek	2 months	June 13	....	20,000	
2.	April 24	Chunnu	Chunnu	1 month	May 27	P.N. Bank	10,000	
							30,000	

Posting of Bills Payable Book :

Dr. **Bills Payable Account** Cr.

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
				2013			
				Apr.30	By Sundries as per Bills Payable Book		30,000

Dr. **Vivek Account** Cr.

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
2013							
Apr.10	To Bills Payable A/c		20,000				

Journal Proper

A Book maintained to record transactions, which do not find place in Special Journals is known as Journal Proper. Following transactions are recorded in the Journal proper:

1. *Opening Entry* : In order to open new set of books at the beginning of new accounting year and record therein opening balances of Assets, Liabilities and Capital, one opening entry is made in the Journal.
2. *Adjustment Entries* : In order to update ledger accounts on accrual basis, entries are made at the end of the accounting period. Entry for Rent outstanding, Prepaid insurance, Depreciation and Commission received in advance is made in the journal.
3. *Rectification entries* : To rectify any accounting error, entries are made in the journal proper.

4. *Transfer entries* : Drawing account is transferred to capital account at the end of the accounting year. Expenses accounts and revenue accounts which are not balanced at the time of balancing are opened to record specific transactions. Accounts relating to operation of business such as Sales, Purchases, Opening Stock, Income, Gains and Expenses etc and drawing are closed at the end of the year and their Total/balances are transferred to Trading, Profit and Loss account by making the journal entries. These are also called **closing entries**.

5. *Other entries* : In addition to the above mentioned entries recording of the following transaction is done in the journal proper :

   - At the time of a dishonour of a cheque the entry for cancellation of discount received or discount allowed earlier.
   - Purchase/sale of items other than goods dealt- in on credit.
   - Goods withdrawn by the owner for personal use.
   - Goods distributed as samples for sales promotion.
   - Endorsement and dishonour of bills of Exchange.
   - Transactions in respect of consignment and Joint Venture, etc.
   - Loss of goods by fire/theft/spoilage.
   - For recording amounts which have become irrecoverable.

Illustration 9

Record the following transactions in the Journal Proper of M/s Nishant Electronics:

(i) Purchased furniture from M/s Furniture House for ₹ 6,000.

(ii) Purchased stationery for office use from M/s Stationery Mart ₹ 700.

(iii) Made full and final payment to M/s Furniture House by Cheque discount allowed by them ₹ 200.

(iv) Prepaid Insurance ₹1,000.

(v) Depreciation on Machinery ₹ 3,000.

(vi) Goods ₹ 5,000 withdrawn by the partner for personal use.

(vii) ₹ 600 not recovered from a debtor.

Solution

Books of M/s Nishant Electronics
Journal Proper

Date	*Particulars*	*L.F.*	*Debit amount (₹)*	*Credit amount (₹)*
(i)	Furniture A/c Dr. To M/s Furniture House (Purchase of Furniture on Credit)		6,000	6,000
(ii)	Stationery A/c Dr. To M/s Stationery Mart (Purchase of Stationery on Credit)		700	700
(iii)	M/s Furniture House Dr. To Discount Received A/c (Discount received)*		200	200
(iv)	Prepaid Insurance A/c Dr. To Insurance Premium A/c (Insurance premium prepaid)		1,000	1,000
(v)	Depreciation A/c Dr. To Machinery A/c (Depreciation charged on Machinery)		3,000	3,000
(vi)	Partner's Capital A/c/Drawings Dr. To Purchases A/c (Goods withdrawn for personal use)		5,000	5,000
(vii)	Bad Debts A/c Dr. To Debtors A/c (Amount not recovered from Debtors)		600	600

** Entry for payment to M/s Furniture House by Cheque is made in the Bank column Cash Book.*

INTEXT QUESTIONS 8.2

I. Which of the following transactions will be entered in the Sales Book, Sales Returns Book or Journal Proper? If the transaction can not to be entered in any of the three write None of these.

(i) Goods sold to Nitin on credit for one month.

(ii) Old furniture sold to Dinesh on credit.

(iii) Salary pre-paid.

(iv) Goods sold to M/s Ramesh Bros.

(v) M/s.Jindal Traders returned goods.

(vi) Depreciation charged on Building.

(vii) Goods destroyed by fire.

(viii) Discount received from M/s N Zone.

(ix) Cash received from M/s Ramesh Bros.

II. Multiple Choice questions :

i. Acceptance by debtors for credit sales of trading items made by the seller have to be recorded in _____________ books.

a) Bills Receivable book b) Bills Payable book

c) Purchases Book d) Journal

ii. Acceptance by debtors for credit purchases of trading items made by the purchaser have to be recorded in ___________ book.

a) Bills Receivable book b) Purchases Book

c) Bills Payable book d) Sales book

WHAT YOU HAVE LEARNT

- **Purchase Journal/Book :** Purchase (journal) book is also a book of original entry. This book records only Credit purchase of goods in which the firm deals.
- **Purchase Returns Journal/Book :** Purchase returns of goods is recorded in this book. Sometimes goods purchased by the supplier are returned for various reasons such as goods are not as per our order, or are defective.
- **Sales Journal :** Transactions relating to Sale of goods dealt-in on credit is recorded in the sales journal.
- **Sale Returns Journal/Book :** Goods returned by the customers are recorded in the Sales return journal/book. The sales returns book does not record the return of goods sold on cash basis.
- When credit sale takes place, a bill of exchange is prepared by the seller of goods and accepted by the purchaser.

- A Bill of Exchange received is recorded in Bills Receivable book. It is posted in the credit side of party's account from the Bills Receivable book.
- A Bill payables is recorded in Bills payable book. It is posted on the debit side of creditors account from Bills Payable book.
- **Journal Proper :** A Book maintained to record transactions, which do not find place in Special Journals, is known as Journal Proper.

Notes

TERMINAL EXERCISE

1. State the meaning of Purchases Book and draw the format of Purchases Book.
2. State the meaning of Purchase Returns Book. Draw the format of Purchase Returns Book.
3. State the meaning of Sales Book and draw its format.
4. State the meaning of Sales Returns Book. Draw the format of Sales Returns Book.
5. Explain the meaning of Journal proper.
6. State the purpose of preparing Bills Receivable and Bills Payble Books.
7. Enter the following transactions in the proper Book of M/s Tina Traders for the month of July 2014 :

2014

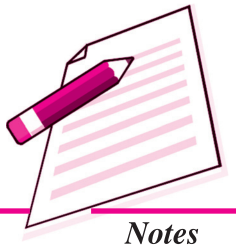
July 01 Bought from M/s.Soniya Traders as per Invoice No.10456
100 Note Books @ ₹ 30 each
50 Gel Pen @ ₹ 10 each
100 Pkt. Color Pencil @ ₹ 15 per pkt.
Trade Discount 10%

July 14 Bought from M/s Lazer Stationery as per Invoice No.2301
100 files @ ₹ 12 per file
10 Rim Paper @ ₹ 300 per rim.
Trade Discount 5%.

July 21 Returned Goods to M/s.Soniya Trader as per Debit Note No.0054
10 Pkt. Color Pencil @ ₹ 15 per pkt.
Trade discount 10%

July 26 Bought from M/s.Shimla paper Mart as per Invoice No.9870
50 pkt water color @ ₹ 50 per pkt.net.

July 31 Returned Goods to M/s. Lazer Stationery as per Debit Note No.0152
3 Rim Paper @ ₹ 300 per rim.
Trade Discount 5%.



8. Enter the following transactions in the proper Book of M/s Electronic Gallery for the month of March 2014 and post them into ledger.

2014

March 02 Sold to M/s Amisha Electronics as per Bill No.0457
4 machine Air Conditioners @ ₹ 15,000 per machine
Trade discount 3%

March 09 Sold to M/s Naman Trader as per Bill No.0475
5 Washing Machines @ ₹ 9,000 per machine set.

March 15 Sold to M/s.Electronic Zone as per Invoice No.486
10 Juicer Mixer Grinders @ ₹ 1,000 each
Trade discount 5%.

March 20 M/s Amisha Electronics returned the goods as per Credit Note No. 112
1 machine Air Conditioner @ ₹ 15,000 per machine
Trade discount 3%

March 25 Sold to M/s Bansal Electronics as per Invoice No.486
5 TV set Color @ ₹ 9,500 per set.
Trade discount 4%

March 31 M/s.Electronic Zone returned the goods as per Credit Note No. 116
2 Juicer Mixer Grinder @ ₹ 1,000 each
Trade discount 5%.

9. Pawan received the following Bills of Exchange. Record them in Bills Receivable Book.

2014

July 01 Drawn on Manish a Bill of Exchange at 2 months which was accepted and returned by him on July 1, 2014 for a sum of ₹ 15,000

July 15 Drawn on Sukant Singh a Bill of Exchange for ₹ 12,000 at 2 months, which was accepted on the Same Day.

July 20 Drawn on Azmat a Bills of Exchange for ₹ 60,000 at 3 months which was accepted and returned by her on July 20 it self.

10. Pawan Singh accepted the following bills. Enter them in Bills Payable Book.

2015

April 05 Accepted Shifali's bill for ₹ 17,000 due at 2 months.

April 13 Accepted the bill drawn by Preena for ₹ 19,000 at 45 days Payable at SBI Aligunj, Lucknow.

April 23 Accepted Rajeev's bill for ₹ 35,000 due at 3 months.

Notes

ANSWERS TO INTEXT QUESTIONS

8.1 (i) Purchases Book (ii) Purchase Returns Book
(iii) None of these (iv) Purchases Book (v) Purchases Book

8.2 I. (i) Sales Book (ii) Journal Proper (iii) Journal Proper
(iv) Sales Book (v) Sales Returns Book
(vi) Journal proper (vii) Journal proper
(viii) Journal proper (ix) None of these.

II. (i) a (ii) c

ANSWERS TO TERMINAL EXERCISE

7. Total of Purchases Book ₹ 10,990, Total of Purchase Returns Book ₹ 990
8. Total of Sales Book ₹ 1,58,300, Total of Sale Returns Book ₹16,450

ACTIVITY

Visit a number of shops/establishments of your areas and enquire whether they are maintaining only journal proper or other special purpose books. Ascertain whether the books maintained by them will serve the purpose or not. If not give suggestions.

	Name of the establishment visited	Number of transactions		Books mentioned	Sufficient/ not sufficient	If not sufficient book to be mentioned
		Quite large	Limited			
1.						
2.						
3.						
4.						
5.						

320en09

9

TRIAL BALANCE

Whenever you attempt a question in arithmetic you try to verify whether your answer is correct or not. If you attempt to solve any other type of problem you want to ensure that it has been correctly solved. For this you try to find out some ways or means. Similarly an accountant also wants to be sure that the ledger accounts he/she has prepared are correct in respect of amount, side, balance, etc. To check the accuracy of posting in the ledger a statement is prepared. This statement is called Trial Balance. You also know that accounts are prepared by applying double entry system. According to this system every debit of a transaction has corresponding credit for the same amount. Hence, the total of debit balances of different accounts in the ledger must be equal to the total of the credit balances in the remaining accounts, provided transactions have been correctly posted in the ledger. A statement is prepared containing these balances with two columns i.e. debit column containing debit balances and credit column containing credit balances and the debit column total is compared with credit column total. If the columnar totals are same it implies that ledger accounts are arithmetically accurate.

In this lesson, you will learn about meaning, objectives and preparation of Trial Balance.

OBJECTIVES

After studying this lesson you will be able to :

- state the meaning of Trial Balance;
- explain the objectives of preparing Trial Balance
- prepare a Trial Balance as per the format;
- identify the need for a Suspense A/c in case the Trial Balance does not tally and
- infer the possibility of errors even if the Trial Balance tallies.

Notes

9.1 MEANING AND OBJECTIVES OF PREPARING TRIAL BALANCE

If you recall the steps in the accounting procedure you find that at first the transactions are entered in the Journal and Special Purpose Books like Cash Book, Purchases Book, Sales Book, etc. From these books items are posted in the ledger in their respective accounts. Finally, at the end of the accounting year these accounts are balanced. To check the accuracy of posting in the ledger a statement is prepared with two columns i.e. debit column and credit column which contains debit balances of accounts and credit balances of accounts respectively. Total of the two columns are if equal, it means the ledger posting is arithmetically correct. This statement is called Trial Balance.

> Trial Balance may be defined as a statement which contains balances of all ledger accounts on a particular date.

Trial Balance consists of a debit column with all debit balances of accounts and credit column with all credit balances of accounts. The totals of these columns if tally it is presumed that ledger has been maintained correctly. However, Trial Balance proves only the arithmetical accuracy of posting in the ledger.

Objectives of Preparing a Trial Balance

Following are the objectives of preparing Trial Balance

(i) To Check Arithmetical Accuracy : Arithmetical accuracy in ledger posting means writing correct amount, in the correct account and on its correct side while posting transactions from various original books of accounts, such as Cash Book, Purchases Book, Sales Book, etc. It also means not only the correct balance of ledger account but also the totals of the special purpose Books.

(ii) To Help in Preparing Financial Statements : The ultimate objective of the accounting is to prepare financial statements i.e. Trading and Profit and Loss Account, and Balance sheet of a business enterprise at the end of an accounting year. These statements contain balances of various ledger accounts. As Trial Balance contains balances of all ledger accounts, in financial statements the balances of ledger accounts are carried from the Trial balance for proper analysis.

(iii) Helps in Locating Errors : If total of two columns of the trial balance agrees it is a proof of arithmetical accuracy in the ledger posting. However, if the totals of the two columns do not tally it indicates that there are some mistake in the ledger accounts. This prompts the accountant to find out the errors.

(iv) Helps in Comparison : Comparison of ledger account balances of one year with the corresponding balances with the previous year helps the management taking some important decisions. This is possible by using the Trial Balances of the two years.

(v) **Helps in Making Adjustments :** While making financial statements adjustments regarding closing stock, prepaid expenses, outstanding expenses etc are to be made. Trial balance helps in identifying the items requiring adjustments in preparing the financial statements.

Trial Balance is generally prepared at the end of the year. However it can be prepared at any time during the accounting year to check the accuracy of the posting.

INTEXT QUESTIONS 9.1

Fill in the blanks with suitable word or words :

(i) Trial balance has .... column and .... column of balances of accounts.

(ii) If totals of two columns of Trial Balance are equal it means the .... is correct.

(iii) Trial Balance proves only the .... accuracy of ledger posting.

(iv) One of the objectives of preparing Trial Balance is helping to locate ....

(v) While preparing .... the ledger account balances are carried from the Trial Balance.

9.2 PREPARATION OF TRIAL BALANCE

Trial Balance is not an account. It is only a list or schedule of balances of ledger accounts including cash and bank balances. It is prepared on a particular date. The accounts having a debit balance are entered in the debit amount column and credit balance accounts are entered in the credit amount column. The totals of the two sides of the accounts may also be used to prepare trial balance. The sum of each column should be equal. The standard format of a trial blance is given below :

Trial Balance of ....
As at ....(closing date)

Name of the Account	*LF*	*Dr. Balance (₹)*	*Cr. Balance (₹)*

The name of the business firm is written on the top of the statement with Trial Balance. Under this we write the date on which Trial Balance is prepared.

Trial Balance has three columns : Name of the Ledger Account, Debit Amount and Credit Amount.

In the ledger account column we write the name of the account. In the Debit amount column we write the amount of debit balance of the account (or the total of the debit side of the account). Similarly in the credit amount column we write the amount of credit balance of the account (or the total of the credit side of the account.

Finally, columnar total is done and compared.

Steps to prepare Trial Balance

(i) At first ascertain the balance account wise of all the ledger accounts.

(ii) Write the name of the ledger account in the ledger account column.

(iii) Write against the name of the ledger account, the balance amount/total amount, debit balance/total in the debit column; and credit balance/total in the credit column.

(iv) Add the debit balance/total amount column and credit balance/total amount column.

There are three methods of preparing Trial Balance

(i) Balance Method : In Balance method, the balance of each account (which may be debit balance or credit balance) is extracted and written against each account; we write debit balance in the debit column and credit balance in the credit column.

(ii) Total Method : In this method the total of both sides of every account in the ledger is written against the name of the respective account without balancing them in the form of debit and credit balances respectively.

(iii) Balance Total Method : Trial Balance is prepared by combining the first and second methods.

However, in practice the trial balance is prepared with debit and credit balances of various accounts in the ledger. Normally balance method is used.

Illustration 1

From the following ledger accounts of a trader closed as on 31st January, 2014, prepare Trial Balance.

Notes

Capital A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan .31	Balance c/d		1,00,000	Jan.31	Bank A/c		1,00,000
			1,00,000				1,00,000
				Feb. 1	Balance b/d		1,00,000

Sales A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan .31	Balance transferred to Trading A/c		70,000	Jan. 8	Bank A/c		24,000
				Jan. 15	Vikram's A/c		46,000
			70,000				70,000

Purchases A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan. 5	Pranaya's A/c		40,000	Jan. 31	Stock A/c		15,000
Jan. 14	Bank A/c		55,000	Jan. 31	Balance transferred to Trading A/c		80,000
			95,000				95,000

Vikram's A/c

Dr. Cr

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
2014				2014			
Jan. 15	Sales A/c		46,000	Jan. 31	Balance cld		46,000
			46,000				46,000
Feb. 1	Balance b/d		46,000				

Pranaya's A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan. 31	Balance c/d		40,000	Jan. 5	Purchases A/c		40,000
			40,000				40,000
				Feb. 1	Balance b/d		40,000

Rent Received A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan. 31	Balance transferred to Profit and Loss A/c		1,500	Jan. 31	Bank A/c		1,500
			1,500				1,500

Bank A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Capital A/c		1,00,000		Purchases A/c		55,000
	Sales A/c		24,000		Commission A/c		1,800
	Rent received		1,500		Drawings A/c		2,000
					Balance c/d		66,700
			1,25,500				1,25,500

Commission A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan. 20	Bank A/c		1,800	Jan. 31	Balance transferred to Profit and Loss A/c		1,800
			1,800				1,800

Notes

Stock A/c

Dr. Cr

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
2014				2014			
Jan. 31	Purchases A/c		15,000	Jan. 31	Balance cld		15,000
			15,000				15,000
Feb. 1	Balance b/d		15,000				

Drawings A/c

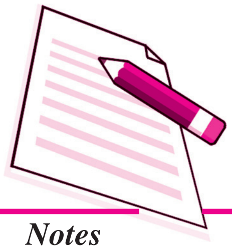
Dr. Cr

Date	*Particulars*	*JF*	*Amount* ₹	*Date*	*Particulars*	*JF*	*Amount* ₹
2014				2014			
Jan. 31	Bank A/c		2,000	Jan. 31	Balance cld		2,000
			2,000				2,000
Feb. 1	Balance b/d		2,000				

Solution :

Trial Balance *as on 31 Jan. 2014*

Name of the Ledger Account	*Dr. Balance (₹)*	*Cr. Balance (₹)*
Capital		1,00,000
Sales		70,000
Purchases	80,000	
Vikram	46,000	
Pranaya		40,000
Commission	1,800	
Rent received		1,500
Drawings	2,000	
Closing Stock	15,000	
Cash at Bank	66,700	
	2,11,500	2,11,500



Notes

Illustration 2

From the following ledger accounts of Rohan Bros prepare Trial Balance by (i) total method (ii) combined method (both balance method and total method) :

Cash A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan. 1	Capital A/c		50,000	Jan. 2	Bank A/c		40,000
Jan. 28	Ranjeet		9,900	Jan. 12	Freight A/c		200
				Jan. 31	Salary A/c		3,000
				Jan.31	Rent A/c		2,400
			59,900				45,600

Bank A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan.2	Cash A/c		40,000	Jan. 8	Furniture A/c		12,000
Jan.14	Sales A/c		16,000	Jan. 10	Purchases A/c		20,000
				Jan.20	Vikas		12,000
				Jan.31	Drawings		4,000
			56,000				48,000

Furniture A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan. 8	Bank A/c		12,000				
			12,000				

Notes

Capital A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2014			
				Jan. 1	Cash A/c		50,000
							50,000

Purchases A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014							
Jan. 10	Bank A/c		20,000				
Jan.12	Vikas		15,000				
			35,000				

Sales A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2014			
				Jan. 14	Bank A/c		16,000
				Jan.20	Ranjeet		14,000
							30,000

Vikas A/c

Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014				2014			
Jan. 20	Bank A/c		12,000	Jan. 12	Purchases A/c		15,000
			12,000				15,000

Ranjeet A/c

Dr. Cr

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
2014				2014			
Jan. 20	Sales A/c		14,000	Jan. 25	Cash A/c		9,900
				Jan.28	Discount A/c		100
			14,000				10,000

Freight A/c

Dr. Cr

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
2014				2014			
Jan. 12	Cash A/c		200				
			200				

Salary A/c

Dr. Cr

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
2014							
Jan. 31	Cash A/c		3,000				
			3,000				

Rent A/c

Dr. Cr

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
2014							
Jan. 31	Cash A/c		2,400				
			2,400				

Drawings A/c

Dr. Cr

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
2014				2014			
Jan. 31	Bank A/c		4,000				
			4,000				

Discount A/c

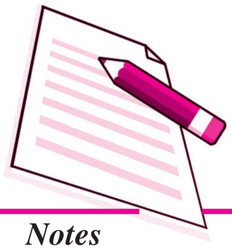
Dr. Cr

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2014							
Jan. 28	Ranjeet		100				
			100				

Solution.

i. (Total Method) **Trial Balance of Rohan Brothers as on 31st January, 2014**

Name of the Ledger Account	*Dr. Balance (₹)*	*Cr. Balance (₹)*
Cash	59,900	45,600
Bank	56,000	48,000
Furniture	12,000	–
Capital	–	50,000
Purchases	35,000	–
Sales		30,000
Vikas	12,000	15,000
Ranjeet	14,000	10,000
Freight	200	–
Salary	3,000	
Rent	2,400	
Drawings	4,000	
Discount	100	
	1,98,600	1,98,600



Notes

ii. (Combine Method) Trial Balance of Rohan Brothers as on 31st January, 2014

Name of the Ledger Account	*Dr.*		*Cr.*	
	Total (₹)	*Amounts (₹)*	*Balance (₹)*	*Amounts (₹)*
Cash	59,900	45,600	14,300	–
Bank	56,000	48,000	8,000	–
Furniture	12,000	–	12,000	–
Capital	–	50,000	–	50,000
Purchases	35,000	–	35,000	–
Sales		30,000	–	30,000
Vikas	12,000	15,000	–	3,000
Ranjeet	14,000	10,000	4,000	–
Freight	200	–	200	–
Salary	3,000	–	3,000	–
Rent	2,400	–	2,400	–
Drawings	4,000	–	4,000	–
Discount	100	–	100	–
	1,98,600	1,98,600	83,000	83,000

INTEXT QUESTIONS 9.2

Fill in the blanks with suitable word/words :

(i) Trial Balance has .... columns.

(ii) There are .... methods of preparing Trial Balance.

(iii) In practice, method of preparing Trial Balance is .... used.

(iv) The last step of preparing trial balance is to ascertain the .... of its two amount columns.

Notes

9.3 TRIAL BALANCE AND ERRORS

You have learnt that if the sum of the two columns of Trial Balance is equal i.e. the Trial Balance is in agreement, it can be assumed that the accounting entries have been arithmetically correct and correctly posted in the ledger. If the totals do not tally it means there are some errors in recording and/or in posting in the ledger of the business transactions.

The reasons due to which the totals of the two columns of Trial balance may not agree can be listed as follows :

(i) The totals of the Special Purpose Books like Sales Book, Purchases Book, etc are not done correctly or there is some mistake in the posting of these totals in their respective accounts in the ledger.

(ii) The items from different Special Purpose Books and Journal may be posted to the wrong side of the account or a wrong amount is posted or posted to the wrong account.

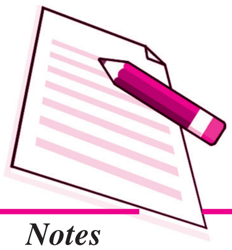
(iii) The balancing of an account is not done correctly.

(iv) There may be mistake in carrying balance from the ledger account to the Trial Balance.

You may conclude that if the trial balance is in agreement, the business transactions have been correctly recorded or posted into ledger. However, the agreement of Trial Balance is not a conclusive proof of the correctness of recording and posting of business transactions. There can be errors and the sum of each column of the Trial Balance may still be equal. As you have learnt that business transactions are so recorded that all debits have the credits for the same amount and vice-a-versa. So the Trial Balance must necessarily agree. But if the debits are matched by credits though there are mistakes in recording and posting the Trial balance will still agree. For example, if goods have been purchased from Surender, and if not entered in the Purchases Book, this error will not affect the agreement of the Trial Balance.

Trial Balance and Suspense A/c

Now suppose the Trial Balance does not agree i.e. there is a difference of some amount in the totals of the two columns of the Trial Balance. What will you do with this difference? A different account i.e Suspense Account is opened with the difference in amount put in this account. This will result in agreement of Trial Balance. The suspense account with the amount of difference will be put on the shorter side of the Trial Balance. For example total of the debit column exceeds the total of the credit column by Rs.500. This amount of Rs 500 will be written on the credit column against Suspense Account to make the Trial Balance agree.



Notes

The suspense A/c is however a temporary arrangement to make the Trial Balance agree. This account will show balance till the error or errors are rectified, this account will disappear as soon as all the errors are rectified.

Illustration 3

From the following Cash Book and Accounts prepare the Trial Balance as on 31st Jaunary 2014.

Cash Book

Dr. Cr

Date	*Particulars*	*L.F.*	*Amount* ₹	*Date*	*Particulars*	*L.F.*	*Amount* ₹
2014				2014			
Jan. 1	Capital A/c		75,000	Jan. 10	Furniture A/c		15,000
Jan. 10	Sales A/c		25,000	Jan. 15	Purchases A/c		25,000
				Jan. 31	Rent A/c		2,000
				Jan. 31	Telephone expenses A/c		1,000
					Balance c/d		57,000
			1,00,000				1,00,000

Ledger

Capital A/c

Dr. Cr

Date	*Particulars*	*L.F.*	*Amount* ₹	*Date*	*Particulars*	*L.F.*	*Amount* ₹
2014				2014			
Jan. 31	Balance c/d		75,000	Jan. 1	Amount as per Cash Book		75,000
			75,000				75,000
				Feb. 1	Balance b/d		75,000

Sales A/c

Dr. Cr

Date	*Particulars*	*L.F.*	*Amount* ₹	*Date*	*Particulars*	*L.F.*	*Amount* ₹
2014				2014			
Jan. 31	Trading A/c		25,000	Jan. 10	Amount as per Cash Book		25,000
			25,000				25,000

Purchases A/c

Dr. Cr

Date	Particulars	L.F.	Amount ₹	Date	Particulars	L.F.	Amount ₹
2014				2014			
Jan. 15	Amount as per Cash Book		25,000	Jan. 31	Trading A/c		25,000
			25,000				25,000

Furniture A/c

Dr. Cr

Date	Particulars	L.F.	Amount ₹	Date	Particulars	L.F.	Amount ₹
2014				2014			
Jan. 10	Amount as per Cash Book		15,000	Jan. 31	Balance cld		15,000
			15,000				15,000

Rent A/c

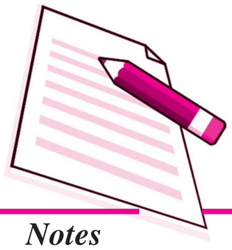
Dr. Cr

Date	Particulars	L.F.	Amount ₹	Date	Particulars	L.F.	Amount ₹
2014				2014			
Jan. 31	Amount as per Cash Book		200	Jan. 31	Profit and Loss A/c		200
			200				200

Telephone charges A/c

Dr. Cr

Date	Particulars	L.F.	Amount ₹	Date	Particulars	L.F.	Amount ₹
2014				2014			
Jan. 31	Amount as per Cash Book		1,000	Jan. 31	Profit and Loss A/c		1,000
			1,000				1,000



Notes

Solution

Trial Balance
As on 31st Jan. 2014

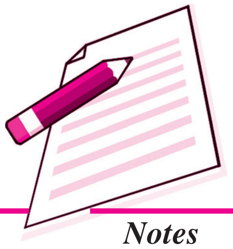
Name of the Account	*Dr. Balances (₹)*	*Cr. Balances (₹)*
Capital		75,000
Sales		25,000
Purchases	25,000	
Furniture	15,000	
Commission		
Rent	200	
Telephone charges	1,000	
Cash in hand	57,000	
Suspense	1,800	
	1,00,000	1,00,000

In the above example we see that the totals of the two columns of the Trial Balance do not tally. Credit side is more than that of debit side by ₹1800. It is to make the two columns of the trial balance equal, suspense A/c is written in the column against it is written the amount of ₹1800 in the debit column. As soon as error/errors are detected and rectified, this suspense A/c will show no balance.

Illustration 4

From the following balances extracted from the books of a trader, prepare Trial Balance as on 31st March, 2014.

	₹
Cash in hand	4,200
Cash at Bank	16,800
Bills Receivable	18,000
Bills payable	16,000
Sundry debtors	24,600
Sundry creditors	32,400
Capital	50,000



Drawings	18,000
Sales	1,05,000
Purchases	75,000
Carriage Inward	2,700
Salaries	12,000
Advertisement	2,400
Insurance	1,600
Furniture	7,500
Stock	18,600
Office Rent	2,000

Solution :

Trial Balance

Name of the Account	*Dr. Balances (₹)*	*Cr. Balances (₹)*
Cash	4,200	
Bank	16,800	
Bills Receivable	18,000	
Bills payable		16,000
Sundry Debtors	24,600	
Sundry creditors		32,400
Capital		50,000
Drawings	18,000	
Sales		1,05,000
Purchases	75,000	
Carriage Inward	2,700	
Salaries	12,000	
Advertisement	2,400	
Insurance	1,600	
Furniture	7,500	
Rent	2,000	
Stock	18,600	
Total	2,03,400	2,03,400

INTEXT QUESTIONS 9.3

Answer the following in one or two words :

(i) If the totals of two amount columns of trial balance do not agree, in which account the difference amount is written?

(ii) If the total of the debit column of a trial balance is more than the total of its credit column in which of the two amount of columns of the trial balance will you write the difference in amount?

(iii) If the total of the Purchases Book is posted to Purchases Account wrongly,. will the trial balance still agree?

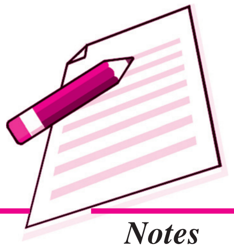
(iv) When the accounting error or errors are rectified what happens to the suspense A/c?

WHAT YOU HAVE LEARNT

- Trial balance is a statement containing balances of all ledger accounts of a business concern on a particular date.
- Trial Balance is prepared to check the arithmetical accuracy of the ledger posting, it helps in preparing financial statements; it helps in locating accounting errors; helps in management as it enables comparison of account balances of different periods and helps in making adjustments while preparing financial statements.
- The totals of two columns of a trial balance should be equal because for each transaction there is debit and credit for the same amount.
- If the totals of two columns of trial Balance tally it means the ledger posting has been correctly done.
- If the totals of two columns of Trial Balance do not agree, it means there is some mistake in the ledger posting.
- If the totals of two columns of Trial Balance do not agree the amount of difference is put to suspense A/c and the totals of Trial Balance are equated.

TERMINAL EXERCISE

1. State the meaning of Trial Balance.
2. Explain in brief the objective of preparing Trial Balance.



Notes

3. Why do the totals of two sides of Trial Balance are equal ? Explain.

4. 'Agreement of Trial Balance is not the conclusive proof of the accuracy of accounts'. Comment.

5. What is Suspense A/c ? What is its role in preparing Trial Balance ?

6. Explain the steps that are taken to prepare a Trial Balance.

7. List the various reasons because of which the totals of two columns of Trial Balance do not tally.

8. Prepare Trial Balance of M/s Multiplying enterprise as on 31st December, 2014.

Accounts	Balances (₹)	Accounts	Balances (₹)
Cash in hand	2,500	Debtors	18,200
Cash at Bank	14,500	Creditors	16,600
Capital	70,000	Opening stock	8,700
Drawing	9,000	Wages	6,700
Purchases	60,000	Rent	5,000
Sales	82,000	Salary	8,400
Machine	35,000	Bills Payable	11,400
Furniture	12,000		

9. Prepare Trial Balance as on 31st March, 2014 from the following balances of Sabana :

Accounts	Dr. Balances (₹)	Cr. Balances (₹)
Cash in hand	3,100	
Bank overdraft		18,250
Opening stock	24,600	
Purchases	59,800	
Sales		72,350
Sabana's Capital		50,000
Drawings	12,000	
Carriage Inward	1,600	
Rent	2,400	
Commission		2,100

Notes

Interest	780	
Furniture	5,220	
Creditors		13,600
Debtors	27,800	
Building	20,000	1,000
Suspense	1,57,300	1,57,300

ANSWERS TO INTEXT QUESTIONS

9.1 (i) debit, credit (ii) ledger posting (iii) arithmetical
(iv) accounting errors (v) financial statements

9.2 (i) Three (ii) Three (iii) balance (iv) sum

9.3 (i) Suspense A/c (ii) Credit side (iii) No (iv) Suspense A/c disappears

ANSWERS TO TERMINAL QUESTIONS

8. Total of two columns are ₹ 180000 each

9. Total of Dr column ₹ 157300
   Total of Cr column ₹ 156300
   Suspense A/c Cr ₹ 1000

ACTIVITY

Talk to your friends who are working as accounts clerk in various firms, and seek answers of the following questions :

1. Do they prepare trial balance?
2. How many times they prepare it in a year and at what intervals?
3. Which method they use total method or balance method?
4. What do they do if Trial Balance does not agree?
5. How many of them prepare the financial statements without preparing Trial balance?

On the basis of the answers prepare a report.

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10

BANK RECONCILIATION STATEMENT

You operate a bank account in which you deposit money and withdraw money from time to time. You maintain a record with yourself of these deposits and withdrawals. One day when you got your pass-book (statement issued by the bank) updated you were surprised to find that the balance shown by the pass book was different from what it should have been as per your records. What will you do in this case? It is obvious that you will compare the two sets of records and find out items which are recorded in one but not in the other. Similar situation may arise in case of a business concern which operates a bank account. These business concerns maintain record of all of their banking transactions in their bank column of the cash book. On any particular date the bank balance shown by the bank column of cash book and that shown by the pass book should be the same. But if there is difference between the two, the business concern will find out the reasons to reconcile the balance. In this lesson you will learn about reasons for difference and prepare the reconciliation statement called Bank Reconciliation Statement.

OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning and need of preparing Bank Reconciliation Statement;
- explain the reasons for difference between the balances of Cash Book and Pass Book and
- prepare the Bank Reconciliation Statement.

10.1 BANK RECONCILIATION STATEMENT - MEANING AND NEED

Business concern maintains the cash book for recording cash and bank transactions. The Cash book serves the purpose of both the cash account and the bank account. It

shows the balance of both at the end of a period. Bank also maintains an account for each customer in its book. All deposits by the customer are recorded on the credit side of his/her account and all withdrawals are recorded on the debit side of his/her account. A copy of this account is regularly sent to the customer by the bank. This is called 'Pass Book' or Bank statement. It is usual to tally the firm's bank transactions as recorded by the bank with the cash book. But sometimes the bank balances as shown by the cash book and that shown by the pass book/bank statement do not match. If the balance shown by the pass book is different from the balance shown by bank column of cash book, the business firm will identify the causes for such difference. It becomes necessary to reconcile them. To reconcile the balances of Cash Book and Pass Book a statement is prepared. This statement is called the 'Bank Reconciliation Statement. It can be said that :

> Bank Reconciliation Statement is a statement prepared to reconcile the difference between the balances as per the bank column of the cash book and pass book on any given date.

Need of preparing Bank Reconciliation Statement

It is neither compulsory to prepare Bank Reconciliation Statement nor a date is fixed on which it is to be prepared. It is prepared from time to time to check that all transactions relating to bank are properly recorded by the businessman in the bank column of the cash book and by the bank in its ledger account. Thus, it is prepared to reconcile the bank balances shown by the cash book and by the bank statement. It helps in detecting, if there is any error in recording the transactions and ascertaining the correct bank balance on a particular date.

INTEXT QUESTIONS 10.1

Fill in the blanks with suitable word/words :

i. The copy of customer's account with the Bank is called ....

ii. The cheques deposited are entered on the .... of the bank column of cash book.

iii. Bank Reconciliation statement is prepared to .... the bank balance as shown by the cash book and the bank statement.

iv. Cheques issued are posted on the .... side of the bank column of Cash Book.

v. The credit column of pass book should be equal to .... column of cash book and debit column of pass book should equal to .... column of cash book, if there are no differences.

Notes

10.2 REASONS FOR DIFFERENCE

When a businessman compares the Bank balance of its cash book with the balance shown by the bank pass book, there is often a difference. As the time period of posting the transactions in the bank column of cash book does not correspond with the time period of posting in the bank pass book of the firm, the difference arises. The reasons for difference in balance of the cash book and pass book are as under :

i. **Cheques Issued By The Firm But Not Yet Presented For Payment :** When cheques are issued by the firm, these are immediately entered on the credit side of the bank column of the cash book. Sometimes, receiving person may present these cheques to the bank for payment on some later date. The bank will debit the firm's account when these cheques are presented for payment. There is a time period between the issue of cheque and being presented in the bank for payment. This may cause difference to the balance of cash book and pass book.

ii. **Cheques Deposited into Bank But Not Yet Collected :** When cheques are deposited into bank, the firm immediately enters it on the debit side of the bank column of cash book. It increases the bank balance as per the cash book. But, the bank credits the firm's account after these cheques are actually realised. A few days are taken in clearing of local cheques and in case of outstation cheques few more days are taken. This may cause the difference between cash book and pass book balance.

iii. **Amount Directly Deposited in The Bank Account :** Sometimes, the debtors or the customers deposit the money directly into firm's bank account, but the firm gets the information only when it receives the bank statement. In this case, the bank credits the firm's account with the amount received but the same amount is not recorded in the cash book. As a result the balance in the cash book will be less than the balance shown in the Pass book.

iv. **Bank Charges :** The bank charge in the form of fees or commission is charged from time to time for various services provided from the customers' account without the intimation to the firm. The firm records these charges after receiving the bank intimation or statement. Example of such deductions is : Interest on overdraft balance, credit cards' fees, outstation cheques, collection charges, etc. As a result, the balance of the cash book will be more than the balance of the pass book.

v. **Interest and Dividend Received by the Bank :** Sometimes, the interest on debentures or dividends on shares held by the account holder is directly deposited by the company through Electronic Clearing System (ECS). But the firm does not get the information till it receives the bank statement. As a consequence, the firm enters it in its cash book on a date later than the date it is recorded by the bank. As a result, the balance as per cash book and pass book will differ.

Notes

vi. **Direct Payments Made By The Bank On Behalf Of The Customers :** Sometimes, bank makes certain payments on behalf of the customer as per standing instructions. Telephone bills, rent, insurance premium, taxes, etc are some of the expenses. These expenses are directly paid by the bank and debited to the firm's account immediately after their payment. but the firm will record the same on receiving information from the bank in the form of Pass Book or bank statement. As a result, the balance of the pass book is less than that of the balance shown in the bank column of the cash book.

vii. **Dishonour of Cheques/Bill discounted :** If a cheque deposited by the firm or bill receivable discounted with the bank is dishonoured , the same is debited to firm's account by the bank. But the firm records the same when it receives the information from the bank. As a result, the balance as per cash book and that of pass book will differ.

viii. **Errors Committed in Recording Transactions by the Firm :** There may be certain errors from firm's side, e.g., omission or wrong recording of transactions relating to cheques deposited, cheques issued and wrong balancing etc. In this case, there would be a difference between the balances as per Cash Book and as per Pass Book.

ix. **Errors Committed in Recording Transactions by the Bank :** Sometimes, bank may also commit errors, e.g., omission or wrong recording of transactions relating to cheques deposited etc. As a result, the balance of the bank pass book and cash book will not agree.

INTEXT QUESTIONS 10.2

Given below are some statements. Some of these statements are true statements and some of these are false statements. Write 'T' for True and 'F' for false statements.

i. Bank credits firm's account as soon as it receives cheques from the firm.

ii. Bank charges are never entered in the Cash Book.

iii. Banks make certain payments on behalf of the customer under his standing instructions.

iv. In case of cheques issued but not encashed, the balance of pass book will be less than the balance of Cash Book.

v. Direct deposits in the bank by a customer would increase the balance shown by the Pass Book.

10.3 PREPARATION OF BANK RECONCILIATION STATEMENT

To reconcile the bank balance as shown in the pass book with the balance shown by the cash book, Bank Reconciliation Statement is prepared. After identifying the reasons of difference, the Bank Reconciliation statement is prepared without making change in the cash book balance.

We may have the following different situations with regard to balances while preparing the Bank Reconciliation statement. These are:

1. Favourable Balances

(a) Debit balance as per cash book is given and the balance as per pass book is to be ascertained.

(b) Credit balance as per pass book is given and the balance as per cash book is to be ascertained.

2. Unfavourable Balance/Overdraft Balance

(a) Credit balance as per cash book (i.e. overdraft) is given and the balance as per pass book is to be ascertained.

(b) Debit balance as per pass book (i.e. overdraft) is given and the balance as per cash book is to be ascertained.

The following steps are taken to prepare the bank reconciliation statement:

Favourable Balances : When debit balance as per cash book or credit balance as per pass book is given :

(a) Take balance as a starting point say Balance as per Cash Book.

(b) Add all transactions that have resulted in increasing the balance of the pass book.

(c) Deduct all transactions that have resulted in decreasing the balance of pass book.

(d) Extract the net balance shown by the statement which should be the same as shown in the pass book.

In case balance as per pass book is taken as starting point all transactions that have resulted in increasing the balance of the Cash book will be added and all transactions that have resulted in decreasing the balance of Cash book will be deducted. Now extract the net balance shown by the statement which should be the same as per the Cash book.

The following illustration helps to understand dealing with the favourable balance as per cash book or pass book.

Illustration 1

From the following particulars of M/s Ananaya Industries, prepare bank reconciliation statement as on December 31, 2014

1. Bank balance as per cash book ₹ 32,500
2. Cheques deposited into bank but not credited upto December 31, 2014 ₹8,900.
3. Cheques issued but not presented for payment ₹ 12,500.
4. Bank credited ₹ 5,000 for receiving dividend through Electronic Clearing System.
5. Bank charges debited by Bank ₹ 400.

Solution

Bank Reconciliation statement of M/s Ananaya Industries
as on December 31, 2014

Particulars	*Plus Amount (₹)*	*Minus Amount (₹)*
1. Balance as per cash book	32,500	
2. Cheques deposited but not credited by the bank		8,900
3. Cheques issued but not presented for payment	12,500	
4. Dividend received through ECS	5,000	
5. Bank charges debited by bank		400
Balance as per pass book		40,700
	50,000	**50,000**

Illustration 2

Take the figures given in illustration number 1. prepare bank reconciliation statement taking balance as per pass book i.e. ₹ 40,700 as the starting point,

Solution

Bank Reconciliation statement of M/s Ananava Industries
as on December 31, 2014

Particulars	*Plus Amount (₹)*	*Minus Amount (₹)*
1. Balance as per pass book	40,700	

Notes

2. Cheques deposited but not credited by the bank	8,900	
3. Cheques issued but not presented for payment		12,500
4. Dividend received through ECS		5,000
5. Bank charges debited by bank	400	
Balance as per Cash book		32,500
	50,000	**50,000**

Illustration 3

From the following particulars of Reema Traders, prepare a bank reconciliation statement on June 30,2014

1. Balance as per the cash book ₹ 35,750
2. ₹ 250 charges for Credit card fee is debited by bank, which is not recorded in cash book.
3. Cheques for ₹ 7,550 are deposited in the bank but not yet collected by the Bank.
4. There was also a debit in the pass book of ₹ 3,500 in respect of a discounted bill dishonoured.

Solution

Bank Reconciliation statement of M/s Reema Traders
as on June 30, 2014

Particulars	*Plus Amount (₹)*	*Minus Amount (₹)*
1.Balance as per Cash book	35,750	
2.Cheques deposited but not credited by the bank		7,550
3.Credit card fee charges debited by the bank		250
4.Discounted bill dishonoured recorded only in Pass Book		3,500
Balance as per Pass book		24,450
	35,750	**35,750**

Illustration 4

Bank Pass book of M/s. Brham Industries showed a credit balance of ₹ 27,350 on July 31,2014. The following differences were found on that date between the cash book and the pass book:

1. Cheques issued before July 31, 2014, amounting to ₹ 19,000 had not been presented for payment.
2. Two cheques of ₹ 5,000 and ₹ 3,500 were deposited into bank on July 31, but the bank gives credit for the same in August.
3. Insurance premium directly paid by bank ₹ 5,000.
4. ₹ 2,000 wrongly debited to the firm account by the bank.

Prepare Bank Reconciliation Statement as on July 31, 2014.

Solution:

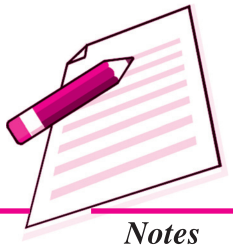
Bank Reconciliation statement of M/s Brahm Industries
as on July 31, 2014

Particulars	*Plus Amount (₹)*	*Minus Amount (₹)*
1. Balance as per pass book	27,350	
2. Cheques issued but not presented for payment		19,000
3. Cheques deposited but credited by the bank in August	8,500	
4. Insurance premium directly paid by bank	5,000	
5. Wrongly debited by the bank.	2,000	
Balance as per Cash book		23,850
	42,850	**42,850**

INTEXT QUESTIONS 10.3

You are given the balance as per Pass Book as the starting point and balance as per Cash Book has to be ascertained by you. Out of the following transactions, write 'A' against those amounts which will be added to the balance of Pass Book and 'R' against those by which balance of Pass Book will be reduced :

1. Interest allowed by Bank
2. Cheques deposited with bank and dishonoured
3. Cheques issued but not encashed
4. Bank charges
5. Insurance premium paid by bank
6. Dividends on share collected by bank.



Notes

10.4 UNFAVOURABLE BALANCE/OVERDRAFT BALANCE

Sometimes a businessman withdraws excess amount from the bank account and the closing bank balance of a month is a debit balance. This balance amount is called 'overdraft balance' as per Pass Book. This is shown in the cash book as a credit balance.

Credit balance as per cash book/Debit balance as per Pass Book.

Overdraft balance is shown in the minus column of statement as the starting point. The other steps shall remain same.

The following illustration will help to understand dealing with the unfavourable balance as per cash book and pass book.

Illustration 5

On December 31, 2014, the cash book of the M/s. Mona Plastics shows the credit balance ₹ 6,500. Cheques amounting to ₹ 3,500 deposited into bank but were not collected by the bank. Firm issued cheques of ₹ 1,000 which were not presented for payment. There was a debit in the pass book of ₹ 200 for interest and ₹ 400 for bank charges. Prepare Bank Reconciliation Statement.

Solution:

Bank Reconciliation statement of M/s Mona Plastics as on December 31,2014

Particulars	*Plus Amount (₹)*	*Minus Amount (₹)*
1. Overdraft as per cash book		6,500
2. Cheques issued but not presented for payment	1,000	
3. Cheques deposited but not credited by the bank		3,500
4. Bank charges and interest charged		600
Overdraft balance as per Bank Pass book	9,600	
	10,600	**10,600**

Illustration 6

Prepare Bank Reconciliation Statement of M/s Ashima Travels, from the following informations:

Bank overdraft as per Cash Book on 31st July, 2014 ₹ 45,000

Cheques issued but not presented for payment ₹ 17,500

Cheques deposited but not yet collected by the bank ₹ 9,600

Interest on investment collected by the bank ₹ 2,300

Bank charges ₹ 350 debited by the bank not yet entered in the cash book.

Solution:

Bank Reconciliation statement of M/s Ashima Travels
as on July 2014

Particulars	*Plus Amount (₹)*	*Minus Amount (₹)*
1. Overdraft as per cash book		45,000
2. Cheques issued but not presented for payment	17,500	
3. Cheques deposited but not credited by the bank		9,600
4. Interest on investment collected by the bank	2,300	
5. Bank charges		350
Overdraft balance as per Bank Pass book	35,150	
	54,950	**54,950**

Illustration 7

From the following particulars of Neha and Co. prepare Bank Reconciliation Statement on March 31,2014

	₹
Overdraft as per pass book	16,500
Interest on overdraft	1,600
Insurance premium paid by the bank	800
Cheques deposited but not yet credited	5,500
Cheques issued but not present for payment	6,000
Wrong credit to firm account by the bank	1,000

Solution:

Bank Reconciliation Statement of M/s Neha & Co
as on March 31, 2014

Particulars	*Plus Amount (₹)*	*Minus Amount (₹)*
1. Overdraft as per pass book		16,500
2. Interest on overdraft	1,600	
3. Insurance premium paid by bank	800	
4. Cheques deposited but not credited by the bank	5,500	
5. Cheques issued but not presented for payment		6,000
6. Wrongly credited by the bank		1,000
Overdraft balance as per cash book	15,600	
	23,500	**23,500**

INTEXT QUESTIONS 10.4

Fill in the blanks choosing correct word from the words given in brackets:

i. Overdraft means .... balance. [Favourable/unfavourable].

ii. The balance of cash book is .... in case of overdraft. [debit/ credit].

iii. Bank charges will .... in case of overdraft as per Cash Book [increase/decrease].

iv. Cheques issued but not encashed will .... in case of the overdraft as per Pass Book. [increase/decrease]

v. Interest allowed by bank .... in case of the favourable balance of cash book. [adds to/reduces]

WHAT YOU HAVE LEARNT

- Bank Reconciliation Statement is a statement prepared to reconcile the difference between the balances as per the bank column of the cash book and pass book on any given date.

- There are certain reasons due to which a difference in the balance of Pass Book and Cash Book take place. These are as follows:

  (a) Cheques issued by the firm but not yet presented for payment.

  (b) Cheques deposited into bank but not yet collected.

  (c) Amount directly deposited in the bank account.

  (d) Bank Charges

  (e) Interest and dividend received by the bank.

  (f) Direct payments made by the bank on behalf of the customer.

  (g) Cheques/discounted bills dishonoured.

  (h) Errors committed in recording transactions by the firm.

  (i) Errors committed in recording transactions by the Bank

- Different situations for preparing the Bank Reconciliation statement. These are:

  Favourable balances

  (a) Debit balance as per cash book is given and the balance as per pass book is to be ascertained.

  (b) Credit balance as per pass book is given and the balance as per cash book is to be ascertained.

  Unfavourable balance/overdraft balance

  (a) Credit balance as per cash book (i.e. overdraft) is given and the balance as per pass book is to be ascertained.

  (b) Debit balance as per pass book (i.e. overdraft) is given and the balance as per cash book is to be ascertained.

TERMINAL EXERCISE

1. What is meant by a Bank Reconciliation statement?

2. What is the need of preparing Bank Reconciliation statement?

3. Enumerate the causes of difference in the balance of cash book and pass book.

4. From the following particulars, prepare Bank Reconciliation statement as on December 31, 2014.

   (i) Balance as per Cash Book ₹ 4,200

(ii) Cheques issued but not presented for payment ₹ 2,000

(iii) Cheques deposited but not collected ₹ 3,000

(iv) Bank charges debited by the bank ₹ 250.

5. Prepare Bank Reconciliation statement as on March 31, 2014. On this date the passbook of M/s Noopur Industries showed a balance of ₹ 27,500.

(a) Cheques of ₹ 14,000 directly deposited by a customer.

(b) Cheques for ₹ 13,500 were issued during the month of March but of these cheques for ₹ 1,500 were not presented by the end of March.

(c) The bank collected ₹ 2,500 as dividend on shares.

(d) Cheques of ₹17500 were paid into bank but of ₹ 8500 were realised in the month of April.

6. On April 1, 2014, Rohan had an overdraft of ₹16,000 as shown by the cash book. Cheques amounting to ₹ 6,000 had been paid by him but not collected by the bank till date. He issued cheques of ₹ 8,000 which were not presented to the bank for payment. There was a debit in his passbook of ₹ 500 for interest and ₹ 200 for bank charges and a cheque of ₹ 5000 was paid into bank but the same was debited twice in the cash book. Prepare Bank Reconciliation Statement.

7. Overdraft shown by the passbook of M/s.Mohit traders is ₹ 40,000. Prepare Bank Reconciliation statement on December 31,2014.

(a) Bank charges debited as per pass book ₹ 1,000

(b) Received a payment directly from customer ₹ 7,000

(c) Cheques wrongly recorded in debit side of cash book ₹ 4,000

(d) Cheques issued but not presented for payment ₹ 9,800

(e) Cheques deposited with the bank but not collected ₹ 12,500

(f) Insurance premium paid by the bank ₹3,500

ANSWERS TO INTEXT QUESTIONS

10.1 (i) Pass Book (ii) Debit side (iii) reconcile (iv) credit (v) Debit, credit

10.2 (i) F (ii) F (iii) T (iv) F (v) T

10.3 (i) R (ii) A (iii) R (iv) A (v) A (vi) R

Notes

10.4 (i) Unfavourable (ii) Credit (iii) Increase

(iv) Decrease (v) Adds to

ANSWERS TO TERMINAL QUESTIONS

4. Balance as per pass Book ₹ 2,950
5. Balance as per Cash Book ₹ 9,500
6. Overdraft as per pass Book ₹ 23,200
7. Overdraft as per cash book ₹ 40,800

ACTIVITY

You know that businessman generally visit their banks to get updated position regarding their bank account. Visit any bank and enquire from the bank officer what discrepencies generally they notice in the items. They have recorded or not recorded the items or not recorded by their customers. Make a list of the discrepencies and show the effect on the bank balance.

S.No.	*Reason of discrepency/actual difference in the bank balance and the balance expected by the customer*	*Effect on account*	
		Plus	*Minus*
1.			
2.			
3.			
4.			
5.			
6.			
7.			

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11

BILLS OF EXCHANGE

You know that now-a-days in business transactions on credit are on the rise. When goods are sold on credit a huge amount of capital is blocked. Then there is no certainity when the amount will be paid. A solution of the problem is giving this fact in writing in proper form so that the buyer or debtor has to pay a definite sum to the seller/creditor on demand or after the expiry of a certain period. Such a formal document duly signed by both the parties is called a Bill of Exchange.

When such a document is given by the debtor/buyer from his own side it is called a promisory note. These two documents when prepared as per provisions of the Negotiable Instruments Act, 1881 attains the position of money and are used for settlement of the amount due. In this lesson you will learn about these two instruments and their accounting treatment in the books of parties concernced.

OBJECTIVES

After studying this lesson you will be able to:

- define the terms 'Bill of Exchange' and 'Promissory Notes';
- distinguish between 'Bill of Exchange' and 'Promisory Note';
- define the terms such as drawer, drawee, days of grace, noting charges etc;
- make enteries in the books of drawer and drawee/payee with respect to drawing & accepting the bill of exchange and meeting the bill of exchange on maturity;
- dishonour of a Bill;
- renewal of Bill;
- insolvency of the acceptor;

Notes

- retiring a bill under rebate;
- discounting the bill from bank; and
- dishonour of bill in various conditions.

11.1 BILLS OF EXCHANGE - MEANING

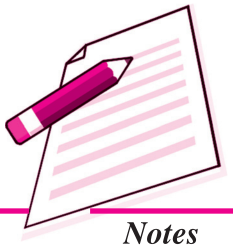
According to section 5 of the Negotiable Instruments Act, 1881, a bill of exchange is an instrument is writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.

Features of Bill of Exchange

1. It is an instrument drawn by the creditor upon his debtor.
2. It contains an unconditional order to pay a specified amount.
3. The specified amount is payable to the person named in the bill or to his order or to the bearer.
4. The bill must be signed/accepted by the maker.
5. The bill specifies the date by which the amount should be paid.
6. It can be payable to the bearer.

Parties to a Bill of Exchange

1. **Drawer :** Drawer is a person who writes/makes the Bill of Exchange. He is generally the creditor who had sold goods on credit.
2. **Drawee :** Drawee is a person upon whom the bill is drawn. He is generally the debtor to whom goods have been sold on credit. Bill is generally signed and accepted by the Drawee.
3. **Acceptor :** He is the person who accepts the bill of exchange. Generally debtor/drawee is the acceptor but sometimes a bill of exchange may be accepted by some one also on behalf of the debtor/drawee. Normally the drawee and acceptor are the same parties.
4. **Payee :** Payee is the person named in the Bill of exchange. The amount in the bill is paid to the payee. In most cases Drawer and the payee will be the same.



SPECIMEN OF A BILL OF EXCHANGE

New Delhi, June 17, 2014

₹ 45,000

Stamp

Three months after date pay Sh. Raj Kumar or order the sum of Rupees Forty Five Thousand only, value received.

To

Rohit Banerji

Shri Nand Kishor
Shakarpur, Delhi

11.1.1. Promissory Note

According to secton 4 of the Negotiable Instruments Act, 1881, A Promissory Note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person.

Promissory Note is an unconditional undertaking in writing by the maker to pay the specified amount to the specified person or to the bearer of the promissory note.

Features of a Promissory Note

1. It is an unconditional written undertaking to pay the specified amount.
2. It is drawn and signed by the maker/promisor.
3. It specifies the name of the payee.
4. The specific amount is payable to the specified person or to his order or to the bearer.
5. Proper stamp duty is paid on Promissory Note.
6. It is not payable to the bearer.

Parties of a Promissory Note

1. **Drawer :** He is the person who makes the promise to pay the amount. He is the debtor.
2. **Drawee :** He is the person in whose favour the promissory note is drawn. Generally he is the creditor. In a promissory note the drawee and payee are the same parties.
3. **The Payee :** The payee is a person to whom payment is to be made. He is the creditor.

SPECIMEN OF A PROMISSORY NOTE

New Delhi, June 17, 2014

₹ 25,000

Stamp

Three months after date we promise to pay M/s Rajesh Enterprises or order a sum of Rupees Twenty Five Thousand only with interest at ten percent per annum, value received.

Rahim Brothers

11.1.2 Difference between Bill of Exchange and Promissory Note

Bill of Exchange	*Promissory Note*
1. It contains an order to pay.	1. It contains a promise to pay.
2. It requires acceptance.	2. It does not need acceptance.
3. Creditor is the Drawer.	3. Debtor is the drawer.
4. The liability of the drawer arises only if the acceptor does not pay.	4. The promisor has the primary liability to pay.
5. The drawer, and payee are generally the same parties. Acceptor and draweer is the Same party.	5. Drawee and Payee are the parties

INTEXT QUESTIONS 11.1

Fill in the blanks :

i. Acceptance is not required in ________________.

a) Bill of Exchange b) Promissory Note

c) Receipt d) None of the above

ii. _____________ prepares the bill of exchange

a) Drawer b) Drawee c) Endorsee d) Bank

iii. Payment of the bill is made to _____________.

a) Drawee b) Endorsee c) Payee d) Bank

Notes

11.2 TERMS OF BILL

1. **Due Date :** It is the date on which the payment of the bill becomes due.

2. **Days of Grace :** To ascertain the period of the bill, three extra days are added, which can be called as 'Days of Grace' to calculate the date of maturity.

3. **Bill at Sight :** Bills which are payable on presentation to the Drawee are known as 'Bill at Sight or Demand'.

4. **Bill After Date :** The period is counted from the date of acceptance of the bill in 'Bill After Date'.

5. **Discounting of Bill :** The process of receving the bill amount at a date earlier than the due date from the bank, is known as 'Discounting the Bill'. When the bill is discounted the bank credits the trader's account after decucting some discount. The discount is calculated at the lending rate of the bank for the period that extends between the date of discounting of the bill to the date of maturity.

6. **Endorsement of the Bill :** The drawer may transfer the bill in favour of his creditor to settle the creditor's account. The process of transferring the ownership of the bill in favour of somebody by putting the signature of the holder at the back of the instrument and delivering the same to transferee is known as endorsing the bill. The person who delivers it is endorser and the person to whom it is delivered is called the endorsee.

7. **Terms of the Bill :** Bills is generally drawn for a certain period, say for two months or three months. Bills may be drawn payable at sight on demand, on presentation, after date and so on.

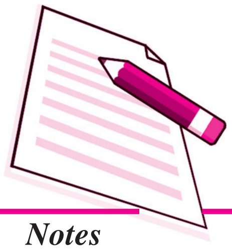
8. **Date of Maturity :** It is the date of which the payment of the bill is due. It is calculated by adding three days of grace. For example a bill drawn on 1.1.2013 for a period of two months will mature on (2 months + 3 days) 3rd March, 2013.

9. **Dishonour of a Bill :** Dishonour means that the bill is not paid by a Drawee on the due date. It arises when the acceptor refuses or is unable to pay the amount of bill, *i.e.,* Bill of Exchange, Promissory Note or cheque.

10. **Notary Public :** Notary Public is an officer appointed by the Central or State Government to exercise the power and functions relating to noting and protesting of negotiable instruments for dishonour. 'Noting' authenticates the fact of dishonour.

11. **Noting Charges :** Noting Charges is the fee paid to the Notary Public for noting and protesting the Bill of Exchange of it's dishonour.

12. **Renewal of Bill :** When the acceptor of a bill is not in a position to meet the bill on due date, he may, with the consent of the holder accept a fresh bill in place of



Notes

the old bill, it is called **Renewal of a Bill**. The fresh bill may include interest for the extended period (or it may be paid separately), stamp duty and other incidental expenses incurred by the holder.

13. **Retirement of Bill :** When the Drawee pays the bill before its due date, it is called **Retirement of a Bill**. The holder allows him a rebate of certain amount calculated at a certain rate per cent per annum, from the date of retirement to the date of maturity.

11.3 RECORDING OF BILL TRANSACTIONS

Before starting recording the bill transactions there are certain important aspects related to recording that you must understand clearly. A bill transaction can be recorded in the books of all the parties related to a bill of exchange if that transaction affects the concerned party in any way. As you know that the person who draws the bill of exchange is called the drawer. He is generally a creditor of the person upon whom the bill of exchange is drawn. The person upon whom bill of exchange is drawn is called the drawee. He is generally the debtor of the person who draws the bill of exchange. For the drawer who receives the bill of exchange after its acceptance by the drwee, the bill of exchange is a bills receivable since he will receive the payment on the maturity of the bill. Bills receivables are assets. For the drawee upon whom the bill of exchange is drawn and who accepts it, the bill of exchange becomes a bills payable because he has to make the payment of the amount on the maturity of the bill when the bill will be presented to him. Bills payables are liabilities. The following procedure is followed for recording the bill transactions boths in the books of the drawer/creditor and drawee/acceptor/debtor in a comparative form.

Books of Seller/Creditor/Drawer		*Books of Buyer/Drawee/Acceptor/Debtor*	
i. For Sale of goods		i. For purchase of goods	
Buyer's A/c	Dr.	Purchases A/c	Dr.
To Sales A/c		To Seller's A/c	
ii. For drawing and receiving bill		ii. For accepting bill	
Bills Receivables A/c	Dr.	Seller's A/c	Dr.
To Buyer's A/c		To Bills Payable A/c	

A bills receivable can be treated by its receiver in any of the following ways before its maturity.

i. He may retain the bill with him till the date of its maturity and present the same to the acceptor for payment on the date of its maturity.

ii. He may discount the bill with his bank.

iii. He may endorse the bill in favour of his creditor.

iv. A few days before the maturity he may send the bill to his bank for the purpose of collection.

The following accounting treatment will be done under the different situations given above.

(i) When the bill in retained by the drawer till its maturity and presented to the drawee/acceptor on its maturity.

Books of drawer/creditor		*Books of drawee/acceptor/payee*	
Bank A/c	Dr.	Bills Payable A/c	Dr.
To Bills Receivable A/c		To Bank	

(ii) On Discounting the Bill : The receiver of the bill may get the bill discounted from its bank at any time before its maturity. The bank charges discount at the pervailing rate of lending and credits the remaining amount in the account of the customer. The following entry will be passed.

Books of drawer/creditor		*Books of drawee/acceptor/debtor*
Banks A/c	Dr.	No entry will be made since he is not affected on the discounting of the bill.
Discount A/c	Dr.	
To Bills Receivable A/c		

On the date of maturity the bill, will be presented by the bank to the acceptor for payment.

Books of drawer	*Books of acceptor/drawee*	
No entry Since he had already discounted the bill from the bank, hence no entry will be passed.	Bills Payable A/c	Dr.
	To Bank	

(iii) When the bill is endorsed by the receiver in favour of his creditor.

Books of Receiver/Drawer		*Books of Acceptor/Drawee*
Creditor's A/c	Dr.	No entry. Since he will not be affected by the endorsement of the bill.
To Bills Receivable		

On maturity of the bill, the bill will be presented by the creditor, to the acceptor for money payment. The following entry will be made.

Books of drawer		
No entry. Since he is not affected	Bills Payable A/c	Dr.
	To Bank	

(iv) When the bill is sent to the bank for collection a few days before maturity.

Books of Receiver/Creditor		*Banks of drawee/acceptor*	
a) For sending		No entry.	
Bill sent for collection	Dr.	Since he is not effected.	
To Bills Receivable			
b) For collection of bill by bank		Bills Payable A/c	Dr.
Bank A/c	Dr.	To Bank	
To Bills sent for collection.			

INTEXT QUESTIONS 11.2

I. Choose the correct option from the following alternatives:

i. Which account is debited in the books of drawer when a bill is drawn.
a) Endorsee b) Bills Receivable
c) Drawee d) Bank

ii. When the acceptor pays the bill amount, which account is credited in the books of drawee.
a) Bills Payable b) Bills Receivable
c) Bank d) Name of the above

II. Fill in the blanks with correct word:

i. The status of acceptor of a bill is that of a _________.
a) Debtor b) Creditor
c) Maker d) None of the above

ii. The drawer of a bill of exchange is the ___________.
a) Debtor b) Creditor
c) Endorsee d) All of the above

iii. __________ is the person to whom payment is made.
a) Buyer b) Drawee
c) Payee d) None of the above

Illustration 1

Ravi sold goods ₹ 5000 to Mohan on credit. He drew a bill of exchange for the same amount upon Mohan payable after date two months. Mohan accepted the bill and returned the same to Ravi. On the due date the bill was presented to Mohan who met the same.

Pass the necessary journal entries in the books of Ravi and Mohan under the following circumstances.

i. When the bill was retained by Ravi till the date of its maturity.

ii. When Ravi discounted the bill from the bank on the same day at 6% p.a.

iii. When Ravi endorsed the bill in favour of his creditor Mukesh.

iv. When Ravi sent the bill a few days before its maturity to its bank for collections.

Solution :

Books of Ravi
Journal

Date	Particulars	L.F.	Debit Amount ₹	Credit Amount ₹
	(a) (i)			
	Mohan's Ac. Dr.		5,000	
	To Sales			5,000
	(Sold goods to Mohan)			
	(ii)			
	Bills Receivables A/c Dr.		5,000	
	To Mohan's A/c			5,000
	(Received Mohan's acceptance payable after two months)			
	Cash/Bank A/c Dr.		5,000	
	To Bills eceivable			5,000
	(Mohan met his acceptance on maturity)			
	(b) Entry (i) & (ii) will be same			
	Bank A/c Dr.		4,950	
	Discount A/c Dr.		50	
	To Bill Receivable A/c			5,000
	(Mohan's acceptance discounted with Bank)			
	(c) Entry (i) & (ii) to will be same as in (a) above.			

	Mukesh A/c Dr.		5,000	
	To Bills Receivable A/c			5,000
	(Mohan's acceptance in our favour endorsed in favour of Mukesh)			
	(d) Entry (i) & (ii) will be same as in (a) above			
	Bills sent for collection Dr.		5,000	
	To Bills Receivable A/c			5,000
	(Mohan acceptance in our favour sent to bank for collection)			

Books of Mohan
Journal

	(a) (b) (c) & (d)			
	Purchases A/c Dr.		5,000	
	To Ravi's A/c			5,000
	(Purchased goods)			
	Ravi's A/c Dr.		5,000	
	To Bills Payable			5,000
	(Accepted Ravis draft)			
	Bills Payable A/c Dr.		5,000	
	To Cash/Bank			5,000
	(Our acceptance in favour of Ravi met on maturity)			

Note : Whatever may happen to the bill before the date of maturity the acceptor is not affected. He will meet the bill on maturity & pass the same entry is all the cases.

11.4 DISHONOUR OF A BILL

If the acceptor fails to pay the amount of the bill on the due date, the bill is said to have been dishonored. When the bill is dishonoured all the previous transactions in connection with the bill are treated as cancelled. Hence, the acceptor is liable to the drawer, the drawer to the endorsee and the endorsee to the bank, with which it is discounted.

The dishonoured bill must be noted with the Notary Public. When the dishonoured bill is noted with the Notary Public, it is a valid evidence of dishonour. The fees charged by the Notary Public is termed as 'Noting Charges.'

On Dishonour of a bill the journal entries will be as under :

In the books of Drawer

a) When the bill was retained by drawer and dishonoured and noting charges are paid

Drawee	Dr.
To Bills Receivable	
To Cash	
(Being B/R dishonoured on due date and noting charges paid)	

b) When the bill was endorsed and dishonoured and noting charges are paid by endorsee.

Drawee	Dr.
To Endorsee	
(Being B/R received from drawee and endorsed is dishonoured, noting charges ₹ ....)	

c) When the bill was discounted with the bank and dishonoured and bank paid noting charges

Drawee	Dr.
To Bank	
(Being discounted bill is dishonoured and noting charges being ₹ ....)	

d) When the bill was sent to bank for collection and dishonoured and bank paid noting charge.

Drawee	Dr.
To Bills sent for collection	
To Bank	
(Being B/R sent to bank for collection is dishonoured and noting charges Rs .... paid by bank)	

In the books of Drawee, the journal entry will be as under in all the four conditions:

Bills Payable	Dr.
Noting Charges	Dr.
To Drawer/creditor	
(Being B/P dishonoured and noting charges ₹ ....)	

11.5 RENEWAL OF BILL

If the acceptor finds it difficult to honour the bill on the due date, he can request the drawer or the holder of the bill to substitute the old bill with a new one *i.e.,* to extend the period of the bill. When the drawer agrees to extend the period of the bill, the old

Notes

bill is cancelled and a new bill is drawn. When the old bill is cancelled, it is treated as dishonoured. Drawee will be charged with interest for the extended period. If the interest is not paid in cash, the new bill amount will include interest also. Therefore, the cancellation of the existing bill and drawing a new bill in its place to allow more time to the acceptor is known as renewal of the bill. On renewal of a bill the entries will be as under :

In the books of Drawer	*In the books of Drawee*
i. Drawee Dr. To Bills Receivable (Being old bill cancelled)	i. Bill Payable Dr. To Drawer (Being cancellation of bill payable)
ii. Drawee Dr. To Interest (Being interest charged for the extended period)	ii. Interest Dr. To Drawer (Being interest due to Drawer for the extended period)
iii. Bills Receivable Dr. To Drawee (Being a new bill received from Drawee including the interest)	iii. Drawer Dr. To Bills Payable (Being a new bill issued for the amount plus interest)

Illustration 2

A sold goods to B for ₹ 10,000 and drew a bill on him for the same amount for 3 months. Before the due date, B requests A to cancel the bill, to accept ₹ 3,000 as part payment and to draw a fresh bill on him for ₹ 7,200 for a further period of 2 months - ₹ 200 being the interest for the extended period. A agrees to the proposal. The new bill is duly honoured. Pass the necessary Journal entries and other party's account in the books of both the parties.

Solution :

In the Books of *A*
JOURNAL

Date	*Particulars*	*L.F.*	*Dr. (₹)*	*Cr. (₹)*
	B ...Dr. To Sales A/c (Being the goods sold to *B* on credit)		10,000	10,000
	Bills Receivable A/c ...Dr. To *B* (Being the bill drawn on B for 3 months)		10,000	10,000

Notes

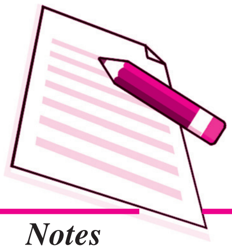
	B ...Dr. To Bill Receivable A/c (Old bill cancelled)		10,000	10,000
	Cash/Bank A/c ...Dr. To *B* (Being cash received as a part-payment)		3,000	3,000
	B ...Dr. To Interest A/c (Being the interest charged for the extended period)		200	200
	Bills Receivable A/c ...Dr. To *B* (Being a new bill drawn for the balance plus interest)		7,200	7,200
	Cash/Bank A/c ...Dr. To Bills Receivable A/c (Being the new bill honoured)		7,200	7,200

Dr. ***B's Account*** Cr.

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
	To Sales A/c		10,000		By Bills Receivable A/c		10,000
	To Bills Receivable A/c		10,000		By Cash/Bank A/c		3,000
	To Interest A/c		200		By Bills Receivable A/c		7,200
			20,200				20,200

In the Books of *B*
JOURNAL

Date	*Particulars*	*L.F.*	*Dr. (₹)*	*Cr. (₹)*
	Purchases A/c ...Dr. To *A* (Being the goods pruchased on credit from *A*)		10,000	10,000
	A ...Dr. To Bills Payable A/c (Being the acceptance of a bill from A)		10,000	10,000
	Bills Payable A/c ...Dr. To *A* (Being the bill cancelled for renewal)		10,000	10,000



Notes

	A ...Dr. To Cash/Bank A/c (Being a part payment made)		3,000	3,000
	Interest A/c ...Dr. To *A* (Being the interest payable to *A* for the extension period)		200	200
	A ...Dr. To Bills Payable A/c (Being the acceptance of a new bill for the balance plus interest)		7,200	7,200
	Bills Payable A/c ...Dr. To Cash/Bank A/c (Being the new bill honoured by payment)		7,200	7,200

Dr. **A's Account** **Cr.**

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
	To Bills Payable		10,000		By Purchases		10,000
	To Bank		3,000		By Bills Payable		10,000
	To Bills Payable		7,200		By Interest		200
			20,200				20,200

Illustration 3 : (When the bill is renewed)

B owed to *A* ₹ 60,000 on 1st January, 2009. On the same date, *A* drew upon *B* a bill for the amount at 2 months and *B* returned the bill duly accepted. *A* got the bill discounted at his bank @ 15% p.a. Before the bill was due for payment, *B* told *A* that he was not able to pay the full amount and requested *A* to accept ₹ 20,000 immediately and drew upon him another bill for the remaining amount for 2 months together with interest @ 18% p.a. *A* agreed. The second bill was duly met. Give the Journal entries in the books of both *A* and *B*.

Solution :

A's JOURNAL

Date	*Particulars*	*L.F.*	*Dr. (₹)*	*Cr. (₹)*
2009 Jan. 1	Bills Receivable A/c ...Dr. To *B* (Being the receipt of *B*'s acceptance to clear the amount due from him)		60,000	60,000

Notes

Jan. 1	Bank A/c ...Dr. Discount on Bill A/c ...Dr. To Bills Receivable A/c (Being discounting of the bill @ 15% p.a.)		58,000 1,500	 60,000
Mar. 4	*B* ...Dr. To Bank A/c (Being the dishonour [for renewal] of *B*'s Bill)		60,000	 60,000
Mar. 4	Cash/Bank A/c ...Dr. To *B* (Being the receipt of ₹ 20,000 from *B*)		20,000	 20,000
Mar. 4	*B* ...Dr. To Interest A/c (Being the interest due from *B* for 2 months on ₹ 40,000 @ 18% p.a.)		1,200	 1,200
Mar. 4	Bills Receivable A/c ...Dr. To *B* (Being the new acceptance received from *B* for ₹ 40,000 balance, plus ₹ 1,200 interest)		41,200	 41,200
May 7	Cash/Bank A/c ...Dr. To Bill Receivable A/c (Being the amount of the bill received)		41,200	 41,200

B's JOURNAL

Date	*Particulars*	*L.F.*	*Dr.* (₹)	*Cr.* (₹)
2009				
Jan. 1	*A* ...Dr. To Bills Payable A/c (Being the acceptance of *A*'s draft)		60,000	 60,000
Mar. 4	Bills Payable A/c ...Dr. To *A* (Being the entry required to got the bill renewed)		60,000	 60,000
Mar. 4	*A* ...Dr. To Cash/Bank/A/c (Being the amount paid to *A* as per arrangement)		20,000	 20,000

Mar. 4	Interest A/c ...Dr. To *A* (Being the amount of interest due to *A* on ₹ 40,000 for 2 months @ 18%)		1,200	1,200
Mar. 4	*A* ...Dr. To Bills Payable A/c (Being the new acceptance in favour of *A*)		41,200	41,200
May 7	Bills Payable A/c ...Dr. To Cash/Bank A/c (Being the payment of the bill due this day)		41,200	41,200

INTEXT QUESTIONS 11.3

Fill in the blanks :

i. Acceptance is not required in __________.

a) Bill of Exchange b) Promissory Note

c) Receipt d) None of the above

ii. __________ prepares the bill of exchange.

a) Drawer b) Drawee c) Endorsee d) Bank

iii. Payment of the bill is made to _________.

a) Drawee b) Endorsee c) Payee d) Bank

iv. The number of days allowed as Days of Grace of Bill of Exchange is ______.

a) One b) Two c) Three d) Five

v. When the amount in a bill of exchange is received from the bank on a date earlier than the due date, it is called ________.

a) Retiring the bill b) Renewing the bill

c) Discounting the bill d) None of the above

vi. The process in which the drawer puts his signature in the bill indicating that the bill should be paid to the person whose name is written at the back of bill is called ________.

a) Discounting the bill b) Endorsing the bill

c) Retiring the bill d) Renewing the bill

11.6 INSOLVENCY OF THE ACCEPTOR

If the acceptor is unable to meet his liabilities, the court declares him as insolvent. In case the acceptor becomes bankrupt, his bills payable are considered as dishonoured.Any amount received from the insolvent person's property, will be debited in the cash account and credited in the Acceptor's Account. Any balance in his account, which is irrecoverable, is written off as bad debts. The Acceptor will transfer the balance in the account of the drawer to Deficiency Account.

The entries relating to insolvency are as follows :

In the books of Drawer		*In the books of Drawee*	
Drawee	Dr.	Bills Payable A/c	Dr.
To Bill Receivable		To Drawer's A/c	
(Cancellation of bill)		(Cancellation of own acceptance)	
Cash	Dr.	Drawer	Dr.
Bad Debts	Dr.	To Cash	
To Drawee		To Deficiency A/c	
		or	
		To Profit & Loss A/c	
(Being the amount received and the amount written off on ___'s insolvency)		(Being the final payment to drawer and the balance transferred to deficiency A/c)	

Illustration 4

Journalise the following in the books of Mohan :

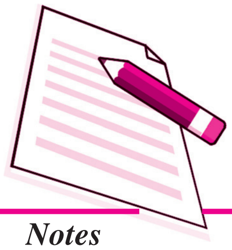
(i) Mohan's acceptance to Sohan for ₹ 20,000 renewed at 3 months together with interest @ 18%.

(ii) Shyam requests Mohan to renew his acceptance for ₹ 15,000 for 2 months. Mohan agrees to it, provided interest is paid @ 10% in cash.

Solution :

JOURNAL OF MOHAN

Date	*Particulars*	*L.F.*	*Dr. (₹)*	*Cr. (₹)*
(i)	Bills Payable A/c ...Dr.		20,000	
	To Sohan			20,000
	(Being cancellation of acceptance in favour of Sohan for purposes of renewal)			



Notes

	Interest A/c ...Dr. To Sohan (Being interest due to Sohan @ 18% for 3 months on ₹ 20,000)		900	900
	Sohan ...Dr. To Bills Payable A/c (Being new bill accepted in favour of Sohan)		20,900	20,900
(ii)	Shyam ...Dr. To Bills Receivable A/c (Being cancellation of Shyam's acceptance for purpose of renewal)		15,000	15,000
	Shyam ...Dr. To Interest A/c (Being interest due from Syam @ 10% for two months, the period of the new bill)		250	250
	Bills Receivable A/c ...Dr. Cash/Bank A/c ...Dr. To Shyam (Being cash ₹ 250 and new bill for ₹ 15,000 received from Shyam)		15,000 250	15,250

11.7 RETIRING A BILL UNDER REBATE

Sometimes the acceptor pays the amount of his bills payable before the due date. The payment of bill amount by the acceptor to the holder before the due date, is known as 'retiring the bill'. In such cases, the holder of the bill would grant some concession to the acceptor. This concession is called as rebate. Rebate is a loss to the holder. It will be a gain to the acceptor.

Entries for rebate are

In the books of Drawer

Cash Dr.
Rebate Dr.
To Bills Receivable
(Being the B/R retired under rebate)

In the books of Drawee

Bills Payable Dr.
To Cash
To Rebate
(Being B/P retired)

Illustration 5

Rohit draws a bill on Vikram for ₹ 10,000 payable 3 months after date. The bill is duly accepted by Vikram. One month before due date Vikram meets the bill and gets a rebate @ 12% p.a. Make Journal entries in the books of Rohit and Vikram.

Notes

In the books of Rohit

Bills Receivable	...Dr.	10,000	
To Vikram			10,000
(Received Vikram's acceptance)			
Cash A/c	...Dr.	9,900	
Rebate A/c	...Dr.	100	
To B/R A/c			10,000

In the books of Vikarm

Rohit	...Dr.	10,000	
To B/P A/c			10,000
(Accepted Rohit's draft)			
B/P A/c	...Dr.	10,000	
To Cash A/c			9,900
To Rebate A/c			100

INTEXT QUESTIONS 11.4

Fill in the blanks :

i. ___________ acount is debited in the books of drawer when bill is duly met and the bill is retained up to the maturity date.

a) Cash b) Cash and Discount

c) Discount d) Bills Receivable

ii. In the books of endorsee when endorsement occurs _______ account is credited.

a) Bills Receivable b) Bills Payable

c) Endorsee d) Endorser

iii. The balance in the Bills sent for collection Account is shown in Balance Sheet as __________.

a) Asset b) Liability

c) Capital d) None of the above

iv. If the payment of the bill is not made on the due date, it is called _________.

a) Discounting the bill b) Dishonour of a bill

c) Retiring the bill d) Renewal of a bill

v. In the books of drawer, when a bill is dishonoured ________ account is debited.

a) Drawee's b) Cash

c) Discount d) None of the above

vi. When the acceptor request the holder to extend the period of bill, it is called.

a) Retiring the bill b) Discounting the bill

c) Renewing the bill d) Endorsing the bill

vii. When the acceptor is declared as insolvent, the entry in the books of drawer is debited with __________.

a) Cash b) Bad debt

c) Cash and bad debt d) Drawee

viii. If the acceptor pays the bill amount before the due date, it is called _________.

a) Discounting the bill b) Retiring the bill

c) Renewing the bill d) Endorsing the bill

WHAT YOU HAVE LEARNT

- A Bill of Exchange is an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.
- Parties to a Bills of Exchange are :
  - i. The Drawer : The party who makes the bill.
  - ii. The Drawee : The party upon whom the bill is drawn.
  - iii. The Payee : The party to whom the amount is to be paid.
  - iv. The Acceptor : The person who accepts the bill. Generally the drawee and acceptor may be the same parties.
- There may be four situations of a bill drawn :
  - i. It may be retained till due date.
  - ii. It may be discounted with bank.
  - iii. It may be endorsed.
  - iv. It may be sent to bank for collection.

TERMINAL EXERCISE

1. What do you mean by a bill of exchange. Distinguish between Bill of Exchange and Promissory Note.
2. Define Bill of Exchange. What are the features of Bill of Exchange?
3. Explain Bill of Exchange along with its advantages and disadvantages.

4. Who are the parties to bill of exchange? Explain them.

5. Explain the following terms :

i.	Renewal of a bill	ii.	Retirement of a bill
iii.	Noting charges	iv.	Days of grace

6. What is meant by a Promissory Note? Describe the parties to a Promissory Note.

7. Briefly explain the characteristics of a Promissory Note.

8. On 1st January, 2008, *A* sold goods to *B* for ₹ 5,000 and drew upon him a bill for this amount payable 3 months after date. The bill was duly accepted by *B*. *A* retained the bill till due date. On the due date, the bill was paid.

   Pass the Journal entries in the books of *A* and *B*. Also, show the necessary accounts in the books of both parties.

9. Dinesh received from Shridhar an acceptance for ₹ 3,000 on 1st September, 2008 at 3 months. Dinesh got the acceptance discounted at 9% p.a. from his bank. On the due date, Shridhar paid the required amount.

   Give the Journal entries in the books of Dinesh and Shridhar.

10. *A* sold goods to *B* for ₹ 20,000 on credit of 3 months. He drew on the latter a bill for the amount. The bill was endorsed in favour of *C*, who got the payment on maturity. Give the Journal entries in the books of *A*.

11. *A* sold goods to *B* for ₹ 2,000. *B* accepts two bills of ₹ 1,000 each for 3 months. A endorsed one bill to *C*. On due date both bills are met.

    Pass the entries in the books of *A* and *B*.

12. Mohan Singh draws a bill on Jagat for ₹ 1,000 payable 2 months after date. Immediately after its acceptance, Mohan Singh sends the bill to his bank for collection. On due date, bank gets the payment. Make the entries in the books of all the parties.

13. On 1st March, 2009 *R* accepted a Bill of Exchange of ₹ 20,000 from *S* payable 3 months after date in full settlement of his dues. On the same day *S* endorsed the Bill of Exchange to *T* together with a cheque for ₹ 5,000 in settlement of his debt to the latter. On 2nd March, 2009, *T* discounted the bill of exchange @ 6% p.a. with his bankers. On maturity the Bill of Exchange was dishonoured.

    Pass the Journal entries in the books of S and R.

14. Record the following transactions in the books of Mehra :

    i. Ram's acceptance for ₹ 20,000 renewed for 3 months, plus interest at 5% p.a.

Notes

ii. Shyam's acceptance for ₹ 4,500, due this day, returned dishonoured. Noting charges, ₹ 10.

15. *A* sold goods to the value of ₹ 12,000 to *B*, taking a bill at 3 months, therefore dated 1st July, 2009. On 4th August, *A* discounted the bill at 5% p.a. with his bankers. At maturity the bill was renewed and drew another bill dishonoured, *B* paid Rs. 3,000 and noting charges and accept another bill at 3 months for ₹ 9,000 at 6% interest, but before maturity he had become insolvent, and ultimately paid his creditors 75 paise in the rupee.

Make the entries in *A*'s Journal recording the above transactions.

ANSWERS TO INTEXT QUESTIONS

11.1	(i) b	(ii) a	(iii) c		
11.2	**I.**	(i) b	(ii) c		
	II.	(i) a	(ii) b	(iii) b	
11.3	(i) b	(ii) a	(iii) c		
	(iv) c	(v) c	(vi) b		
11.4	(i) a	(ii) b	(iii) d	(iv) a	(v) b
	(vi) a	(vii) c	(viii) c	(ix) b	

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12

ERRORS AND THEIR RECTIFICATION

You did not take your studies seriously that is why you could not get good marks. You committed an error. You fell in some bad company. You may commit many such errors in your day to day life. Similarly, an accountant can also commit errors while recording business transactions in books of accounts, in their posting or balancing the accounts and so on. These errors should be located and corrected as soon as possible so that accounts give true and fair results of the operations of the business enterprise. You have learnt that in case Trial Balance does not agree it means there are some accounting errors. There can be some errors which do not affect the Trial Balance i.e. trial balance still tallies. In this lesson you will learn about locating, classifying and analysing accounting errors and their rectification.

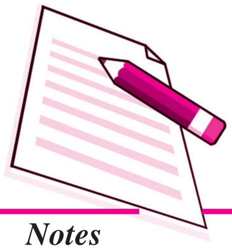
OBJECTIVES

After studying this lesson you will be able to :

- state the meaning of accounting error and method of location of the accounting error/errors;
- classify the accounting errors;
- explain the meaning and methods of rectification of errors and
- prepare suspense account.

12.1 MEANING OF ACCOUNTING ERRORS AND THEIR LOCATION

In our life we make many mistakes. As soon as these are detected, he/she corrects them. In the similar manner, an accountant can also make mistakes or commit errors while recording and posting transactions. These are called 'Accounting Errors'. So



Notes

accounting errors are the errors committed by persons responsible for recording and maintaining accounts of a business firm in the course of accounting process. These errors may be in the form of omitting the transactions to record, recording in wrong books, or wrong account or wrong totalling and so on.

Accounting errors can take the following forms:

- Omission of recording a business transaction in the Journal or Special purpose Books
- Not posting the recorded transactions in various books of accounts to the respective accounts in ledger
- Mistakes in totalling or in carrying forward the totals to the next page
- Mistake in recording amount wrongly, writing it in a wrong account or on the wrong side of the account.

Again there may be two types of accounting errors (i) That cause the disagreement of trial balance, (ii) That do not affect the agreement of Trial Balance.

Locating Errors

It is obvious that if there are errors they must be located at the earliest. After locating the errors, they are to be rectified. In accounting also once it is established there are some accounting errors these need to be located and detected as early as possible. How to locate the errors?

Steps to be taken to locate the accounting errors can be stated as follows:

(A) When the Trial Balance does not Agree

(i) Check the columnar totals of Trial Balance

(ii) Check that the balances of all accounts (including cash and bank balances) in the ledger have been written and are written in the correct column of trial balance i.e. debit balance in the debit column and credit balance in the credit column.

(iii) Find the exact figure of difference with trial balance and see that:

(a) No account of a similar balance has been omitted to be shown in the Trial Balance or

(b) A balance amount which is half of the amount of difference amount but is written on the wrong side of the trial Balance.

(iv) Recheck the totals of Special Purpose Books.

(v) Check the balancing of the various accounts in the ledger.

(vi) If difference is still not traced, check each and every posting from the Journal and various Special Purpose Books, one by one in the ledger.

(B) When the Trial Balance Agrees

You have already learnt that if the totals of the two amount columns of trial balance tally it is no conclusive proof of the accuracy of accounts. There may still be some accounting errors. These errors may not be immediately traced but may be detected at much later stage. These are rectified as and when detected.

Following are the errors which don't affect the trial balance :

(i) Omission to record a transaction in a journal or in a Special Purpose Book. For example, goods purchased on credit but are not recorded in the Purchases Book at all.

(ii) Recording a wrong amount of an item in journal or in a Special Purpose Book. For example, sale of ₹ 2550 on credit entered in the Sales Book as ₹ 5250.

(iii) Posting the correct amount on the correct side but in wrong account. For example, cash received from Jagannathan was credited to Vishvanathan.

(iv) An item of Capital Expenditure recorded as an item of Revenue Expenditure and vice-a-versa. For example, Repairs to Building was debited to Building A/c.

Why does the trial balance still agree though there may be above stated errors? Reason is that in the above cases the debits and credits are affected simultaneously by the same amount.

INTEXT QUESTIONS 12.1

Do the following errors affect the trial balance or do not affect the trial balance? Write 'Yes' if it affects and 'No' if does not affect.

i. Sold goods of ₹ 3200 to Anil Nayar, but it is not entered in the Sales Book.

ii. Purchased goods of ₹ 2400 from Simran and is correctly entered in the Purchases Book but posted to the credit of her account in the ledger as ₹3400.

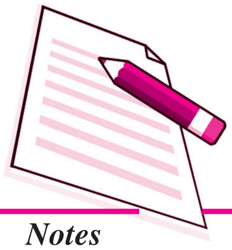
iii. Total of the Purchases Book is incorrect.

iv. An amount of repair to building is debited to Building Account.

12.2 CLASSIFICATION OF ACCOUNTING ERRORS

Various accounting errors can be classified as follows :

A. On the basis of their nature



Notes

(a) Errors of omission

(b) Errors of commission

(c) Errors of principle

B. On the basis of their impact on ledger accounts

(a) One sided errors

(b) Two sided errors.

A. On the basis of their nature

(a) ***Errors of omission :*** As a rule, a transaction is first recorded in books of accounts. However, accountant may not record it at all or record it partially. It is called an error of omission. For example, goods purchased on credit are not recorded in Purchases Book or discount allowed to a customer was not posted to Discount A/c in the ledger.

In the first case it is a complete omission. Therefore, both debit and credit are affected by the same amount. Therefore, it does not affect the Trial Balance.

The second example is the example of partial omission. It affects only one account i.e. Discount A/c. Therefore it affects Trial Balance.

(b) ***Errors of commission :*** When the transaction has been recorded but an error is committed in the process of recording, it is called an error of commission. Error of commission can be of the following types:

(i) Errors committed while recording a transaction in the Special Purpose books. It may be :

- Recording in the wrong book for example purchase of goods from Rakesh on credit is recorded in the Sales Book and not in the Purchases Book.

- Recording in the book correctly but wrong amount is written. For example, goods sold to Shalini of ₹ 4200 was recorded in the Sales Book as ₹ 2400

In the above two cases two accounts are affected by the same amount, debit of one and the credit of the other. Therefore, trial balance will not be affected.

(ii) Wrong totalling : There may be a mistake in totalling Special Purpose Book or accounts. The totalled amounts may be less than the actual amount or more than the actual amount. First is a case of undercasting and the other of overcasting. For example, the total of Purchases Book is written as ₹ 44800 while actual total is ₹ 44300, the total of Sales Day Book is written as ₹52500 while it is ₹ 52900.

It is a case of an error affecting one account hence it affects trial balance.

(iii) Wrong balancing : While closing the books of accounts at the end of the accounting period, the ledger accounts are balanced. Balance is calculated of the totals of the two sides of the account. It may be wrongly calculated. For example, the total of the debit column of Mohan's A/c is ₹ 8,600 and that of credit column is ₹ 6,800. The balance calculated is as ₹ 1,600 while the actual balance is ₹1,800.

It has affected one account only, therefore, the Trial Balance gets affected.

(iv) Wrong carry forward of balances or totals : Totals or balances are carried forward to the next page. These may be carried forward incorrectly. For example, the total of one page of the Purchases Book of ₹ 35,600 is carried to next page as ₹ 36,500.

Again the error affects one account only. Therefore, Trial Balance gets affected.

(v) Wrong Posting : Transactions from the journal or special purpose books are posted to the respective accounts in the ledger. Error may be committed while carrying out posting. It may take various forms such as, posting to wrong account, to the wrong side of the account or posted twice to the same account. For example goods purchased of ₹ 5400 from Rajesh Mohanti was posted to the debit of Rajesh Mohanti or posted twice to his account or posted to the credit of Rakesh Mohanti.

In the above examples, only one account is affected because of the error therefore, Trial Balance is also affected.

Compensating Errors

Two or more errors when committed in such a way that there is increase or decrease in the debit side due to an error, also there is corresponding decrease or increase in the credit side due to another error by the same amount. Thus, the effect on the account is cancelled out. Such errors are called compensating errors. For example, Sohan's A/c is debited by ₹ 2500 while it was to be debited by ₹ 3500 and Mohan's A/c is debited by ₹ 3500 while the same was to be debited by ₹ 2500. Thus, excess debit of Mohan's A/c by ₹1000 is compensated by short credit of Sohan's A/c by ₹1000.

As the debit amount and the credit amount are equalised, such errors do not affect the agreement of Trial Balance, but the fact remains that there is still an error.

(c) Error of Principle : Items of income and expenditure are divided into capital and revenue categories. This is the basic principle of accounting that the capital receipts and capital expenditure should be recorded as capital item and revenue

income and revenue expenditure should be recorded as revenue item. If transactions are recorded in violation of this principle, it is called error of principle i.e. the capital item has been recorded as revenue item and revenue item is recorded as capital item. For example, ₹ 5000 spent on the repairs of building is debited to Building A/c while it should have been debited to Repair to Building A/c. It is a case of error of principle because expenditure on repairs of building is a revenue expenditure, while it has been debited to Building A/c taking it as an item of capital expenditure.

As both the sides i.e. credit as well as debit remain affected, the trial Balance also is not affected by such errors.

B. On the basis of impact on ledger accounts

Errors may affect one side i.e. either debit or credit side of an account or its two sides i.e. both debit and credit thus errors may be divided as:

(a) ***One sided errors :*** Accounting errors that affect only one side of an account which may be either its debit side or credit side, is called one sided error. The reason of such error is that while posting a recorded transaction one account is correctly posted while the corresponding account is not correctly posted. For example, Sales Book is overcast by ₹ 1000. In this case only Sales A/c is wrongly credited by excess amount of ₹ 1000 while the corresponding account of the various debtors have been correctly debited. Another example of one sided error is ₹ 2500 received from Ishita is wrongly debited to her account. In this case, only Ishita's account is affected, amount in the cash-book is correctly written. This type of error does affect the trial balance.

(b) ***Two sided errors :*** The error that affects two separate accounts, is called two sided error. Example of such error is purchase of machinery for ₹ 1000 has been entered in the Purchases Book. In this case, Purchases A/c is wrongly debited while Machinery A/c has been omitted to be debited. So two accounts i.e. Purchases A/c and the Machinery A/c are affected.

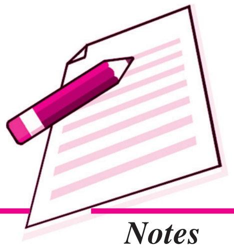
INTEXT QUESTIONS 12.2

Following are some accounting errors. Write against each error the type i.e. error of omission, error of principle, compensatory error, error of commission as per the nature of error:

(i) Purchase of Furniture is entered in the Purchase Book (Error of ....)

(ii) Repairs of building is debited to Building A/c. (Error of ....)

(iii) Sales Book is totalled ₹ 15,000 instead of its ₹ 14,600. (Error of ....)



Notes

(iv) Mohan's A/c was to be debited by ₹ 4500 and Sohan A/c was to be debited by ₹ 5500 while Mohon's A/c was debited by ₹ 5500 and that of Sohan's A/c by ₹ 4500. (Error of ....)

12.3 RECTIFICATION OF ACCOUNTING ERRORS

By now you must have understood well that every business enterprise prepares its financial statements to provide information of profit earned or loss incurred by it during an accounting period and its financial position on the relevant date. This information will be most useful only if the information is accurate. How can the business concern achieve this objective if there are number of errors in the accounting? Your immediate response will be that errors in accounts should be detected at the earliest and be corrected before preparing the financial statements.

It should be clear in your mind that the errors should never be rectified by erasing or overwriting because it will encourage manipulations and frauds in accounts.

In accounting practice there are some definite methods to rectify the accounting errors. These are based on accounting practices and procedures. Rectification of errors using these methods is called rectification of accounting errors. So it is a process of rectification. It is generally done by passing an entry to nullify the effect of error.

Methods of rectification of accounting errors :

I. Before preparing Trial Balance

(i) instant correction (ii) correction in the affected account

II. After preparing Trial Balance

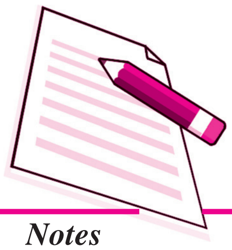
I. Before preparing Trial Balance

(i) Instant correction : If the error is detected immediately after making an accounting entry, it may be corrected by neatly crossing out the wrong entry and making the correct entry and the accountant should put his initials. For example, an amount of ₹ 3,500 is written as ₹ 5,300. This can be corrected as ₹ 3,500.

(ii) Correction in the affected accounts : In case error is detected on a date later than the date on which the transaction was recorded but before the Trial Balance, the rectification will be made by making a correction in the affected account. A few Illustrations of accounting errors corrected by this method are as follows :

Illustration 1

Purchases book is overcast for the month of July, 2014 by ₹ 8,000.



Notes

Solution

Accounts Affected : The total of the Purchase Book is posted to the debit of Purchase A/c. Therefore Purchase A/c is affected.

Rectification : To nullify the effect of the error, the entry of ₹ 8,000 will be made on the credit side of the Purchase A/c. With the words written as. "The amount of Purchase Book is overcast for the month of July 2014."

Purchase A/c

Dr Cr

Date	*Particulars*	*F*	*Amount (₹)*	*Date*	*Particulars*	*F*	*Amount (₹)*
					Amount as per Purchase Book for the month of July, 2014		8,000

Illustration 2

A sum of ₹ 1,200 paid to Ashok has been wrongly credited to his account.

Solution

Accounts Affected : Ashok A/c is affected because his account has been credited instead of being debited.

Rectification : In this case Ashok A/c is to be debited to nullify the effect of its being wrongly credited at the same time it is to be debited for cash payment. Rectification is done as under :

Ashok A/c

Dr Cr

Date	*Particulars*	*F*	*Amount (₹)*	*Date*	*Particulars*	*F*	*Amount*
	Amount paid wrongly credited		2,400		Cash A/c		1,200

Illustration 3

Purchase of furniture of ₹ 5,000 was entered in the Purchases Book.

Solution

Accounts Affected : Furniture Account and Purchases account have been affected. Furniture Account has been omitted to be debited while Purchases account is wrongly debited.

Rectification : In this case Purchases account is credited to nullify as it is wrongly debited as furniture account is debited in it was to be debited but was omitted.

Furniture A/c

Dr Cr

Date	Particulars	F	Amount (₹)	Date	Particulars	F	Amount (₹)
2014 Jan 15	Amount transferred Purchase A/c		5,000				

Purchases A/c

Dr Cr

Date	Particulars	F	Amount (₹)	Date	Particulars	F	Amount (₹)
				2014 Jan 15	Amount transferred to Furniture A/c		5,000

Rectification Through Journal entry

In case of the above illustration journal entry for rectification made is :

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
2014 Jan 15	Furniture A/c		5,000	
	To Purchases A/c			5,000
	(Furniture purchased on credit is wrongly entered in the purchases Book is now corrected)			

Illustration 4

Amount of ₹ 15,000 received from Govind was credited to Har Govind.

Solution

The two accounts affected are Govind's A/c which is not credited and Har Govind's A/c which is wrongly credited.

Rectification entry in Journal is :

Har Govind's A/c	Dr	15,000	
To Govind's A/c			15,000
(Amount received from Govind wrongly credited to Har Govind is now rectified.)			

Illustration 5

Following are some accounting errors. Rectify them by making journal entries :

(i) Sales for ₹ 20,000 made to Malvika was not entered in the Sales Book.

(ii) Salary of ₹ 7,500 paid to Accountant Raman was debited to his personal account

(iii) Old furniture sold for ₹ 2,800 was entered in the Sales Book.

(iv) Carriage paid ₹ 500 on purchase of a Machine was debited to Carriage A/c

(v) Cash ₹ 50,000 paid to the creditor Atulya Ghosh was debited to Praful Ghosh's A/c

Solution

Journal

Date	*Particulars*	*L.F.*	*Amount* ₹	*Amount* ₹
(i)	Malvika Dr		20,000	
	To Sales A/c			20,000
	(Sale to Malvika omitted to be entered in Sales Book is corrected)			
(ii)	Salary A/c Dr		7,500	
	To Raman			7,500
	(Salary paid to Raman was debited to his personal account is now corrected)			
(iii)	Sales A/c Dr		2,800	
	To Furniture A/c			2,800
	(Old furniture sold was entered in the sales Book is now corrected)			
(iv)	Machine A/c Dr		500	
	To Carriage A/c			500
	(Amount paid for carriage on purchase of machine is debited to carriage A/c is now corrected)			

(v)	Atulya Ghosh Dr To Praful Ghosh (Amount paid to Atulya Ghosh was debited to Praful Ghosh is corrected)		50,000	50,000

INTEXT QUESTIONS 12.3

i. Cash received from Ashok ₹ 2,500 were posted to his account as ₹ 5,200. Accountant erased amount of ₹ 5,200 and wrote ₹ 2,500 in its place. Is he justified in doing so?

ii. Accountant corrected an error of writing ₹ 7,200 instead of ₹ 5,200 in the following manner, is he justified to do so?

~~₹ 7,200~~

₹ 5,200

iii. Total of the Sales Book was overcast by ₹ 1,000. Accountant corrected the error in the following manner :

Amount as per Sales Book ₹ 1,000

On which side of the Sales A/c he should write the above amount?

iv. Wages paid ₹ 1,200 were omitted to be recorded in the Cash Book. What journal entry will be made to rectify the error?

12.4 RECTIFICATION OF ERRORS THROUGH SUSPENSE ACCOUNT

You have learnt that the Trial Balance prepared at the end of a period by the business concern must agree. It means the sum of its debit column and sum of credit column should agree. But if the totals do not agree the difference amount is written in a new account. This account is called Suspense Account. If the total of the debit side of the Trial Balance is more than the total of its credit side, the difference amount will be written in Suspense A/c on its credit side i.e. Suspense A/c is credited and vice-versa. You have also learnt that the two sides of the Trial Balance do not agree because there is some error or errors in the accounts, which is reflected in the Suspense Account. Thus, Suspense A/c is a summarised account showing net effect of errors.

Opening of a Suspense Account is a temporary arrangement. As soon as the errors that has led to creation of Suspense Account are rectified, this account will disappear. One point needs to be noted that balance shown in Suspense Account is the net result of one sided errors. So one sided errors are corrected through Suspense A/c. Completing

the double entry when an error is corrected by placing the correct amount on the debit of the proper account, the credit is placed in Suspense Account or vice-versa. For example, Gopal's Account was debited short by ₹ 100. The error will be rectified through Suspense A/c by debiting Gopal A/c and crediting Suspense A/c by ₹ 100.

Journal entry for the same is as follows :

Gopal' A/c	Dr.	100	
To Suspense A/c			100
(Gopal's A/c debited short is now corrected)			

Similarly, while correcting as one sided error the proper account is credited with the correct amount, the debit is placed in the Suspense A/c. For example, Sales Book for December, 2014 is undercast by ₹ 500. The error will be rectified by debiting Suspense A/c and crediting Sales A/c.

Journal Entry for the same will be as follows :

Suspense A/c	Dr.	500	
To Sales A/c			500
(Sales Book undercast is rectified)			

Illustration 6

Following are some accounting errors. Rectify the same through Suspense A/c

(i) Purchases Book has been overcast by ₹ 200

(ii) Goods purchased from Manohar of ₹ 2,500 have been posted to the debit of his account.

(iii) Cash of ₹ 4,500 paid to Munish was credited to Manish.

(iv) Discount ₹ 100 allowed to Anthony was not debited to discount account.

Solution

(i) ***Accounting Effect :*** Purchases A/c has been debited in excess by ₹ 200

Rectification : Purchases A/c is credited by ₹ 200 and Suspense A/c is debited by ₹ 200.

Journal Entry

Suspense A/c	Dr	200	
To Purchases A/c			200
(Purchases Book overcast is now corrected)			

Notes

(ii) ***Accounting Effect :*** Manohar A/c has been debited by ₹ 2,500 instead of it being credited by the same amount.

Rectification : Manohar A/c is credited by ₹ 5,000

Journal Entry

Suspense A/c	Dr	5,000	
To Manohar A/c			5,000
(Goods purchased from Manohar wrongly debited to his account now rectified)			

(iii) ***Accounting Effect :*** Manish A/c is credited by ₹ 4,500 while Manish A/c was to be debited by the same amount.

Rectification : Manish A/c is to be debited by ₹ 4,500 and Manish A/c is also be debited by ₹ 4,500 and Suspense A/c to be credited by ₹ 9,000

Journal Entry

Manish	Dr	4,500	
Manish	Dr	4,500	
To Suspense A/c			9,000
(Cash paid to Manish was wrongly credited to Manish, now corrected)			

(iv) ***Accounting Effect :*** Discount A/c is omitted to be debited by ₹ 100. This account is debited and Suspense A/c is credited.

Journal Entry

Discount A/c	Dr	100	
To Suspense A/c			100
(Discount allowed is not debited to discount A/c.)			

Illustration 7

Rectify the following accounting errors through Suspense Account by making journal entries :

1. Purchase of goods from Mohit for ₹ 2,500 was entered in the Sales Book, however Mohit's Account was correctly credited.
2. Cash received from Anil a debtor ₹ 3,200 was correctly entered in the Cash Book but was omitted to be posted to his account.
3. Sales Book was overcast by ₹ 1,500.

Notes

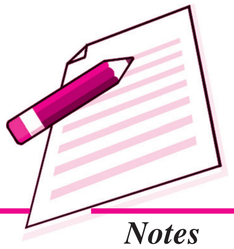
4. Cash of ₹ 4,000 paid to Hanif was credited to Rafique A/c as ₹ 1,400.
5. The total of Purchase Returns Book of ₹ 3,150 was carried forward as ₹1,530.
6. Namita was paid cash ₹ 6,500 but Sumita was debited by ₹ 6,000.

Solution

Date	Particulars	L.F.	Amount Dr. (₹)	Amount Cr. (₹)
1.	Purchases A/c Dr		2,500	
	Sales A/c Dr		2,500	
	To Suspense A/c			5,000
	(Purchase of good was entered in the the sale book now corrected)			
2.	Suspense A/c Dr		3,200	
	To Anil A/c			3,200
	(Anil's account omitted to be credited now rectified			
3.	Sales A/c Dr		1,500	
	To Suspense A/c			1,500
	(Sales Book overcast is corrected)			
4.	Hanif A/c Dr		4,000	
	Rafique A/c Dr		1,400	
	To Suspense A/c			5,400
	(Cash paid to Hanif was wrongly credited to Rafique the error is now rectified)			
5.	Suspense A/c Dr		1,620	
	To Purchases Returns A/c			1,620
	(Purchase Return Book undercast is now rectified)			
6.	Namita A/c Dr		6,500	
	To Sumita A/c			6,000
	To Suspense A/c			500
	(Cash paid to Namita ₹ 6,500 was debited to Sumita by ₹ 6,000 the error is rectified)			

Rectification of Two Sided Errors

Error which affects two different accounts on the same sides or different sides is called two sided error.



Notes

Illustration 8

Furniture purchased from M/s Furniture House on 15th January, 2014 for ₹ 5000 was wrongly entered in the Purchases Book.

Solution

Accounts affected are Furniture A/c which is omitted to be debited and Purchase A/c which is wrongly debited.

Rectification through Journal Entry

Furniture A/c	Dr	5000	
To Purchases A/c			5000
(Furniture purchased wrongly entered in the Purchases Book now rectified)			

INTEXT QUESTIONS 12.4

Answer the following in one sentence :

i. When is Suspense A/c opened?

ii. When does Suspense A/c disappear?

iii. What are two sided errors?

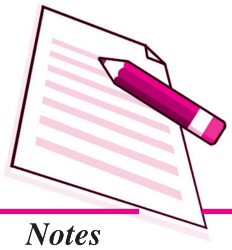
iv. What type of errors are rectified through Suspense A/c?

WHAT YOU HAVE LEARNT

- Accounting errors are the errors committed by persons responsible for recording and maintaining accounts of a business firm in the course of accounting process.
- Errors can be in the form of omission of recording of transaction in various books or posting in ledger or mistake in totalling or recording wrong amount or in wrong account.
- There can be accounting errors which affect the agreement of trial balance and errors which do not affect the agreement of Trial Balance.
- On the basis of nature accounting errors can be

  (a) Errors of omission (b) Errors of commission

  (c) Errors of principle (d) Compensating errors.



Notes

- On the basis of impact on ledger accounts errors can be :

  (a) one sided errors (b) two sided errors
- Errors should never be rectified by erasing or overwriting.
- Methods of rectification of errors are
  (a) Before preparing trial balance, instant correction and correction in the affected account.
  (b) After preparing trial balance through passing a rectifying journal entry.

TERMINAL EXERCISE

1. State the meaning of Accounting Errors.
2. Explain the following types of errors with suitable examples:
   (a) Error of omission
   (b) Compensating errors
   (c) Error of principle
3. A businessman has prepared trial balance of his business firm that has agreed? He is satisfied that now there are no accounting errors. Do you agree with him? If not list the errors that do not affect the agreement of the trial balance.
4. When is a suspense Account opened? How are errors rectified through Suspense A/c?
5. Rectify the following errors :
   (i) Goods purchased on credit for ₹ 8,200 not recorded in the Purchases Book.
   (ii) Purchase Returns Book is overcast by ₹ 1,000.
   (iii) Salary of ₹ 3,200 paid to Gopal the accountant was debited to his personal account
   (iv) Sales to Shakila of ₹ 2,400 was posted to her account
   (v) Cash received from Suresh ₹ 2,000 was not entered in the books.
6. Rectify the following errors :
   (i) Purchases Book is undercast by ₹ 1,500
   (ii) Sales Return Book is overcast by ₹ 1,000
   (iii) Sales Book is added short by ₹ 100

Notes

(iv) The total of Purchases journal of ₹ 7,580 has been posted to Purchases Account as ₹ 5,780

(v) The total of the page of Sales journal of ₹ 24,750 was carried to next page as ₹ 27,450

7. Pass necessary journal entries to rectify the following errors :

   (i) Sale of an old machine for ₹ 4,500 was posted to Sales account

   (ii) Rent of proprietors residence of ₹ 12,000 was posted to Rent Account.

   (iii) A credit to Brij Mohan of ₹ 6,750 was posted to his account as ₹4,750

   (iv) Furniture purchased from M/s Decorates for ₹ 22,500 was entered in the Purchases Book

   (v) Salary paid to the accountant Sushil Gupta of ₹ 6,500 was debited to his personal Account.

8. The Book keeper of a firm found that his trial balance did not agree. Its credit total exceeded the debit total by ₹ 2,850. He placed the amount in Suspense A/c and subsequently found the following errors.

   (i) A credit item of ₹ 3,490 has been debited to his personal Account as ₹ 4,390.

   (ii) A sum of ₹ 2,650 written off as depreciation on machine has not been posted to Depreciation A/c.

   (iii) Goods of ₹ 5,300 sold were returned by the customer and were taken into stock before closing the books but were not entered in the books.

   (iv) ₹ 4,800 due from Lakhan Pal which had been written off as bad debt in a previous year was unexpected recorded and had been posted to the personal account of Lakhan Pal.

   (v) Sales Book is undercast by ₹ 1,500.

   (vi) ₹ 4,000 withdrawn for domestic use by the proprietor was debited to General Expenses A/c.

   (vii) Machine Purchased from Machine Mart for ₹ 18,000 were entered in the Purchases Book.

   (viii) Cash paid ₹ 1,200 to Lakshman was credited to Ram as ₹ 2,100.

ANSWERS TO INTEXT QUESTIONS

12.1 (i) No (ii) Yes (iii) Yes (iv) No

12.2 (i) Principle (ii) Principle
(iii) Commission (iv) Compensating Error

12.3 (i) No (ii) Yes (iii) Debit side

(iv)

Wages A/c	Dr.	1200	
To Cash A/c			1200

12.4 (i) When trial Balance does not agree.
(ii) When errors responsible for suspense account are rectified.
(iii) Errors which affect two different accounts on same sides or different sides.
(iv) One sided errors.

ACTIVITY

Your father has appointed a person to maintain accounts of his business but he is not very competent due to which offen he commits accounting errors. Your father has asked you to look into the accounts and make a list of various errors he commits. Find out which type of errors he commits more frequently. Classify these errors and explain to him how not to make such errors in future.

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13

COMPUTER AND COMPUTERISED ACCOUNTING SYSTEM

With the expansion of business the number of transactions increased. The manual method of keeping and maintaining records was found to be unmanageable. With the introducton of computers in business, the manual method of accounting is being gradually replaced. And finally, the database technology has revolutionised the accounts department of the business. organisations. In this lesson, we will study about characteristics of computer, role of computers in accounting, need of computerised accounting, etc.

OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning and characteristics of computer;
- describe the components of Computer and limitations of computer;
- explain the role of computer in accounting;
- explain the meaning and features of computerised Account.
- differentiate between manual accounting and computerised accounting;
- explain the Accounting Information System;
- describe the basic requirements of computerised accounting and
- understand the sourcing of accounting system.

13.1 COMPUTER AND ITS CHARACTERISTICS

Computer is an electronic device that can perform a variety of operations in accordance with a set of instructions called programme. It is a fast data processing electronic machine. It can provide solutions to all complicated situations. It accepts data from the user, converts the data into information and gives the desired result. Therefore, we may

define computer as a device that transforms data into information. Data can be anything like marks obtained in various subjects. It can also be name, age, sex, weight, height, etc. of all the students, savings, investments, etc., of a country. Computer is defined in terms of its functions.

> Computer is a device that accepts data, stores data, processes data as desired, retrieves the stored data as and when required and prints the result in desired format.

Characteristics of Computer

A Computer is better than human being. It possesses some characteristics. These are as follows:

i. **Speed :** It can access and process data millions times faster than humans can. It can store data and information in its memory, process them and produce the desired results. It is used essentially as a data processor. All the computer operations are caused by electrical pulses and travels at the speed of light. Most of the modern computers are capable of performing 100 million calculations per second.

ii. **Storage :** Computers have very large storage capacity. They have the capability of storing vast amount of data or information. Computers have huge capacity to store data in a very small physical space.

    Apart from storing information, today's computers are also capable of storing pictures and sound in digital form.

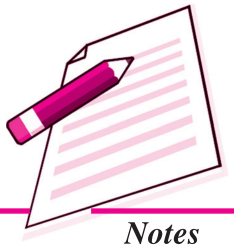
iii. **Accuracy :** The accuracy of computer is very high and every calculation is performed with the same accuracy. Errors occur because of human beings rather than technological weakness; main sources of errors are wrong program by the user or inaccurate data.

iv. **Diligence :** A computer is free from tiredness and lack of concentration. Even if it has to do 10 million calculations, it will do even the last one with the same accuracy and speed as the first.

v. **Versatility :** Computer can perform wide range of jobs with speed, accuracy, and diligence. In any organisation, often it is the same computer that is used for diverse purposes such as accounting, playing games, preparing electric bills, sending e-mail and so on.

vi. **Communication :** Computers are being used as powerful communication tools. All the computers within an office are connected by cable and it is possible to communicate with others in the office through the network of computer.

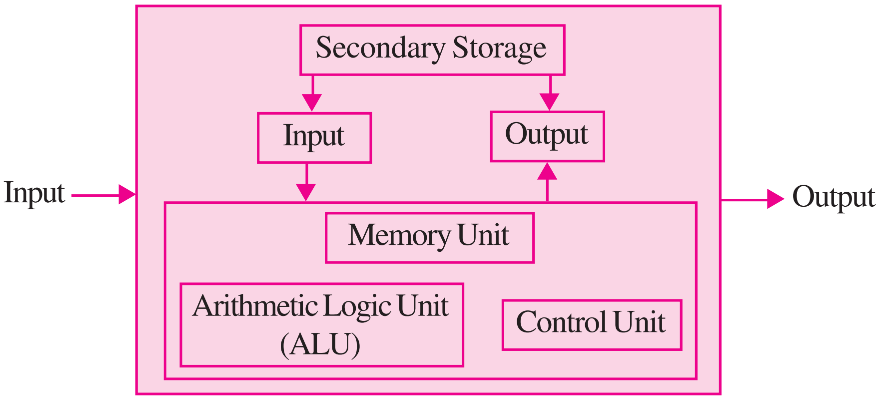
vii. **Processing Power :** Computer has come a long way today. They began as mere prototypes at research laboratories and went on to help the business organisations,



and today, their reach is so extensive that they are used almost everywhere. In the course of this evolution, they have become faster, smaller, cheaper, more reliable and user friendly.

13.2 COMPONENTS OF COMPUTER

A computer consists of the major components *i.e.,* Input Unit, Central Processing Unit and Output Unit. Diagrammatically, these components may be presented as follows:



Components of Computer

- **Input Unit :** Input unit is controlling the various input devices which are used for entering data into the computer. The mostly used input devices are keyboard, mouse, and scanner. Other such devices are magnetic tape, magnetic disk, light pen, bar code reader, smart card reader, etc. Besides, there are other devices which respond to voice and physical touch. Physical touch system is installed at airport for obtaining the online information about departure and arrival of flight. The input unit is responsible for taking input and converting it into binary system.

- **Central Processing Unit (CPU) :** The CPU is the control centre for a computer. It guides, directs and governs its performance. It is the brain of the computer. The main unit inside the computer is the Central Processing Unit. Central Processing Unit is to computer as the brain is to human body. This is used to store program, photos, graphics, and data and obey the instructions in program. It is divided into three subunits :

  (a) ***Control Unit :*** Control unit controls and co-ordinates the activities of all the components of the computer. This unit accepts input data and converts it into computer binary system.

  (b) ***Memory Unit :*** This unit stores data before being actually processed. The data so stored is accessed and processed according to instructions which are also stored in the memory section of computer well before such data is transmitted to the memory from input devices.

(c) Arithmetic and Logic Unit : It is responsible for performing all the arithmetical calculations and computations such as addition, subtraction, division, and multiplication. It also performs logical functions involving comparisons among variable and data items.

- **Output Unit :** After processing the data, it ensures the convertibility of output into human readable form that is understandable by the user. The commonly used output devices include monitor also called Visual Display Unit, printer etc.

INTEXT QUESTIONS 13.1

Fill in the blanks with correct word/words

i. Computer is a fast data .... electronic machine.

ii. All the computer operations are caused by .... pulses and travels at the speed of light.

iii. A computer is free from .... and lack of concentration.

iv. Computers are being used as powerful .... tools.

v. The mostly used input devices are keyboard, ... and scanner.

vi. Central Processing Unit is to computer, as the .... is to human body.

vii. The commonly used output devices include .... printer etc.

13.3 LIMITATIONS OF A COMPUTER AND COMPURISED ACCOUNTING

The limitations of computer are depending upon the operating environment they work in. These limitations are given below as :

- **Cost of Installation :** Computer hardware and software needs to be updated from time to time with availability of new versions. As a result heavy cost is incurred to purchase a new hardware and software from time to time.

- **Cost of Training :** To ensure efficient use of computer in accounting, new versions of hardware and software are introduced. This requires training and cost is incurred to train the staff personnel.

- **Self Decision Making :** The computer cannot make a decision like human beings. It is to be guided by the user.

- **Maintenance :** Computer requires to be maintained properly to help maintain its efficiency. It requires a neat, clean and controlled temperature to work efficiently.

- **Dangers for Health :** Extensive use of computer may lead to many health problems such as muscular pain, eyestrain, and backache, etc. This affects adversely the working efficiency and increasing medical expenditure.

13.4 ROLE OF COMPUTERS IN ACCOUNTING

The most popular system of recording of accounting transactions is manual which requires maintaining books of accounts such as Journal, Cash Book, Special purpose books, ledger and so on. The accountant is required to prepare summary of transactions and financial statements manually. The advanced technology involves various machines capable of performing different accounting functions, for example, a billing machine. This machine is capable of computing discount, adding net total and posting the requisite data to the relevant accounts.

With substantial increase in the number of transactions, a machine was developed which could store and process accounting data in no time. Such advancement leads to number of growing successful organisations. A newer version of machine is evolved with increased speed, storage, and processing capacity. A computer to which they were connected operated these machines. As a result, the maintenance of accounting data on a real-time basis became almost essential. Now maintaining accounting records become more convenient with the computerised accounting.

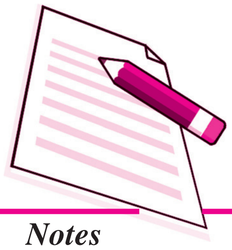
The computerised accounting uses the concept of databases. For this purpose an accounting software is used to implement a computerised accounting system. It does away the necessity to create and maintain journals, ledgers, etc., which are essential part of manual accounting. Some of the commonly used accounting softwares are Tally, Cash Manager, Best Books, etc.

Accounting software is used to implement computerised accounting. The computerised accounting is based on the concept of database. It is basic software which allows access to the data contained in the data base. It is a system to manage collection of data ensuring at the same time that it remains reliable and confidential.

Following are the components of Computerised accounting software:

1. **Preparation of Accounting Documents :** Computer helps in preparing accounting documents like Cash Memo, Bills and invoices etc., and preparing accounting vouchers.

2. **Recording of Transactions :** Every day business transactions are recorded with the help of computer software. Logical scheme is implied for codification of account and transaction. Every account and transaction is assigned a unique code. The grouping of accounts is done from the first stage. This process simplifies the work of recording the transactions.



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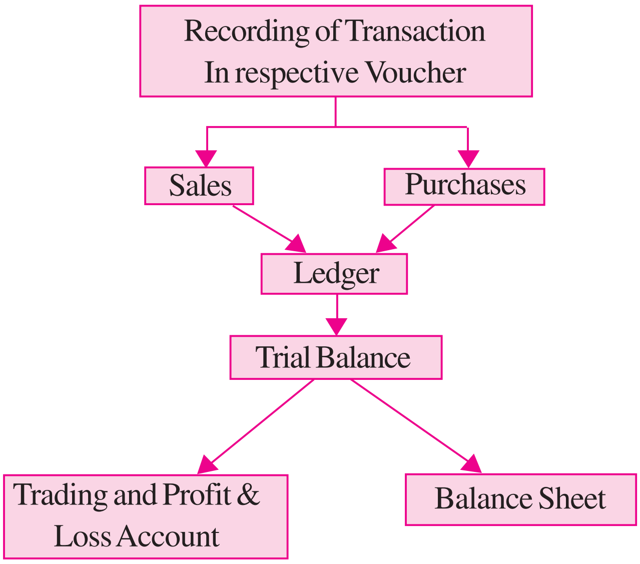
3. **Preparation of Trial Balance and Financial Statements :** After recording of transaction, the data is transferred into Ledger account automatically by the computer. Trial Balance is prepared by the computer to check accuracy of the records. With the help of trial balance the computer can be programmed to prepare Trading, Profit and Loss Account and Balance Sheet. These components can be shown as:



Components of Computerised Accounting Software

13.5 SALIENT FEATURES OF CAS

Following are the salient features requied for CAS software:

1. **Simple and Integrated :** CAS is designed to automate and integrate all the business operations, such as sales, finance, purchase, inventory and manufacturing. CAS is integrated to provide accurate, up-to-date business information rapidly. The CAS may be integrated with enhanced MIS (Management Information System), Multi-lingual and Data Organisation capabilities to simplify all the business processes of the organisation easily and cost-effectively.

2. **Transparency and Control :** CAS provides sufficient time to plan, increases data accessibility and enhances user satisfaction. With computerised accounting, the organisation will have greater transparency for day-to-day business operations and access to the vital information.

3. **Accuracy and Speed :** CAS provides user-definable templates (data entry screens or forms) for fast, accurate data entry of the transactions. It also helps in generalising desired documents and reports.

4. **Scalability :** CAS enables in changing the volume of data processing in tune with the change in the size of the business. The software can be used for any size of the business and type of the organisation.

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5. **Reliability :** CAS makes sure that the generalised critical financial information is accurate, controlled and secured.

6. **Performing various Functions with Accuracy :** Accounting software is used to perform the function of accounting. The software functions on the concept of database. As discussed above, accounting software eliminates the process of posting a transaction into the Ledger Account, that is, when a transaction is entered in the computer system, the posting in the Ledger Account is automatic. The software is so designed that a transaction, once entered, is automatically transported to the Ledger Account also. In the present times, a number of accounting packages are available off-the-shelf in the market. They do a variety of jobs, listed below, for the end users :

   i. Online Input and Storage of Accounting Data;

   ii. On Screen or Physical Output Generation;

   iii. Printout of Vouchers and Invoices;

   iv. Printout of Ledgers and other books of accounts;

   v. Updating of customer accounts in Sales Ledger and supplier accounts in Purchase Ledgers;

   vi. Recording of Suppliers Invoices;

   vii. Recording of Bank Receipts;

   viii. Making payments to supplier and for the expenses;

   ix. Writing Day Books and General Ledger;

   x. Maintenance of Stock Accounts;

   xi. Aged Debtor Summary (who owes what and since when);

   xii. Preparation of Trial Balance, Profit and Loss Accounts and Balance Sheet;

   xiii. Stock Valuations;

   xiv. Payroll Analysis; and

   xv. Statutory Returns, such as VAT and Service Tax.

13.6 GROUPING OF ACCOUNTS

The increase in the number of transaction changes the volume and size of the business. Therefore, it becomes necessary to have proper classification of data. The basic classifications of different accounts embodied in a transaction are resorted through accounting equation.

Accounting Equation

The modern accounting is based on double-entry system, which implies equality of assets and equities (liabilities and capital), i.e.

A = E

Where **E = L + C**

Now **A = L + C**

Where A = Assets

E = Equities

C = Capital

L = Liabilities

Thus, **Assets = Liabilities + Capital**

In this equation the *Liabilities* means claims on the firm by *creditors* and the *Capital* means claims of owners. The claims of owners keep on changing due to success (profit) or failure (loss) of the firm. This is reflected by the income statement, which provides the summary of income and expenses of business for a given accounting period. Keeping this in view, the above equation can be re-written as :

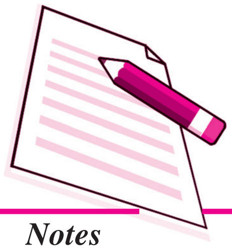
Assets = Liabilities + Capital + (Revenues - Expenses)

Each component of the above equation can be divided into group of accounts as follows:

> ***Revenue*** *means inflow of resources, which results from the sale of goods or services in the normal course of business and increase in capital. Expenses imply consumption of resources in generating revenues.*

- **ASSETS**
  - **Fixed Assets**
    - Land
    - Buildings
    - Plant and Machinery
    - Equipments
    - Furniture and Fixtures
    - Others

- **Current Assets**
  - Cash
  - Bank
  - Debtors
  - Inventories
  - Loans and Advances
- **CAPITAL**
  - **Share Capital**
  - **Reserve and Surplus**
    - Capital Reserve
    - General Reserve
    - Balance of Profit and Loss Account
- **LIABILITIES**
  - Secured Loans
  - Unsecured Loans
  - Creditors
  - Provisions
- **REVENUES**
  - Sales
  - Other Income
- **EXPENSES**
  - Material Consumed
  - Salary and Wages
  - Manufacturing Expenses
  - Depreciation
  - Administrative Expenses
  - Interest
  - Selling and Distribution Expenses



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There is a hierarchical relationship between the groups and its components. In order to maintain the hierarchical relationships between a group and its sub-groups, proper codification is required to ensure neatness of classification.

Main Code	Sub-Code	Account Code	Main Head	Sub Head	Account Head
1 →			Assets		
	1 →			Fixed Assets	
		001 →			Land
		002 →			Buildings
		003 →			Plant and Machinery
		004 →			Electrical Installation
		005 →			Vehicles
		006 →			Furniture and Fixtures
		007 →			Computers

As an example, code for Land Account will be 11001. In the above codification. It has been considered that the enterprise is a single unit enterprise. If the enterprise has more than one unit, then a code may be given for the unit also. Codes may similarly be given for investments, current assets, etc., in the assets side.

Let us take an example of codification of liabilities, say Secured Loan:

Main Code	Sub-Code	Account Code	Main Head	Sub Head	Account Head
2 →			Liabilities		
	1 →			Secured Loan	
		001 →			State Bank of India
		002 →			Punjab Natonal Bank
		003 →			ICICI Bank Ltd.
		004 →			Axis Bank Ltd.

As an example, a transaction with State Bank of India will be given accounting code of 21001. For example, a cheque is deposited in State Bank of India and therefore, State Bank of India is to be debited. Account with code 21001 will be debited.

Same procedure is followed when codification is done for items of Trading, Profit and Loss Account.

Let us take an example of codification of Incomes Head, say Sales for a dealer in electronic goods:

Main Code	Sub-Code	Account Code	Main Head	Sub Head	Account Head
3			Income		
	1			Sales	
		001			Refrigerator Sale
		002			Air-Conditioner Sale
		003			Video Camera Sale
		004			Digital Camera Sale
		005			Plasma TV Sale
		006			TV Sale

As an example, a sale transaction of refrigerator will be given a code 31001.

Let us take an example of codification of Expense Head, say Administration and General Expenses:

Main Code	Sub-Code	Account Code	Main Head	Sub Head	Account Head
4			Expenses		
	6			Administration and General Expenses	
		001			Telephone Expenses
		002			Postage and Telegram
		003			Internet Expenses
		004			Newspaper and Periodicals
		005			Conveyance Expenses
		006			Travelling Expenses

As an example, an expense on telephone will be given a code 46001.

It is not necessary that codification be done using numerical number only it can be using alphabet as codes or even alphanumeric codes. For example, Assets sides may be given a code say 'A'. Fixed Assets may be given 'F' and individual assets accounts be given numeric codes as are given in the illustration. The code for Land Account in the above illustration will be 'AF001'.

Account if wrongly coded, will lead to errors of principle whereby an item of liability may be treated as income and vice versa. Similarly, an item of asset may be treated as

expense and vice versa. The financial statements prepared without rectifying such errors will reveal incorrect financial results and position. Therefore, extreme caution needs to be exercised when grouping of accounts is done and also when the transaction is recorded using computers.

The process of 'Grouping of Accounts' is the basic or fundamental requirement for producing financial statements. The second stage of application of computers in accounting is to record individual transactions using the accounting software. But always bear in mind that accounting concepts shall always be followed.

Using Software of CAS

There are two basic activities in using software of CAS - One time activities and recurring activities. One time activities include creation of Organisation details, accounting year, type of ledger (also called "creation of master files"), et. While recurring activities include entry of transactions and generation of reports. The transactions are recorded on the basis of Cash Vouchers, Bank Vouchers, Purchase Vouchers, Sales Vouchers, Journal Vouchers, etc. Reports include generation of Day books, Ledger, Trial Balance, Profit and Loss Account, Balance Sheet, and Cash Flow Statement.

Security Features of CAS Software

Every accounting software ensures data security, safety and confidentiality. Therefore every, software provides the following:

- **Password Security :** Password is a mechanism, which enables a user to access a system including data. The system facilitates defining the user rights according to organisation policy. Consequently, a person in an organisation may be given access to a particular set of a data while he may be denied access to another set of data.

  Password *is the key (code) to allow the access to the system.*

- **Data Audit :** This feature enables one to know as to who and what changes have been made in the original data thereby helping and fixing the responsibility of the person who has manipulated the data and also ensures data integrity. Basically, this feature is similar to Audit Trial.

- **Data Vault :** Software provides additional security through data encryption.

> ***Encryption*** *essentially scrambles the information so as to make its interpretation extremely difficult (almost impossible). Thus,* ***Encryption*** *ensures security of data even if it lands in wrong hands, because the receiver of data will not be able to decode and interpret it.*

Notes

13.7 SOFTWARES OF COMPUTERISED ACCOUNTING SYSTEM

Computers, with the help of Application Software, perform the same functions that are carried out when accounting is done manually. Let us discuss these.

i. **Payroll Processing :** Payroll Procesing means preparation of salaries and wages, accounting along with the leave records, deduction of provident fund, ESI, etc. Leave records are part of payroll as salaries and wages are prepared taking into account the leaves taken. ESI and Provident Fund are statutory deductions out of salaries and wages and also contribution by the employers.

   Computer takes the data such as Employee's Name, Father's Name, Employee code, Basic Salary, Perquisites, Percentage of deduction for Provident Fund, ESI and advance, etc., from the Master Data and the number of days from the attendance record. It not only produces the salary and wages sheet timely but also accurately. The entry in the financial books of account is recorded from the payroll processing.

ii. **Transaction Recording :** Transactions are recorded using the utility or application software. Transaction recording under the computerised environment is not only accurate but is also less time consuming. It is so because two time consuming processes under the manual system namely posting of entries into ledger accounts and casting (totalling and balancing) are automated by the software. Software are designed in the manner that the process of posting and casting is carried out simultaneously with recording of transaction.

   A functional key is provided to record transactions relating to cash, purchase, sale and journal. It means that if cash transactions are to be recorded the functional key when operated will open the cash book.

iii. **Ledger :** The software is designed in such a manner that the transaction is posted to the ledger account and the ledger account is casted simultaneously with the recording of transaction. We had discussed in this chapter about grouping of accounts. Posting of transaction into ledger account is carried out as guided by the account code given to the transaction.

iv. **Trial Balance :** Posting of transaction into ledger account and also casting of ledger account is carried out simultaneously with the recording of transaction. It means that a trial balance can be extracted even after every transaction without any efforts.

v. **Financial Statements :** Financial Statements, *i.e.,* Trading, Profit and Loss Account and the Balance Sheet like extracting a trial balance can also be extracted after every transaction.

13.8 ADVANTAGES OF COMPUTERISED ACCOUNTING SYSTEM

A computerised accounting system has many advantages, as discussed below:

i. **Large Volume of Transactions :** In the present-day business environment, the transactions of a business are normally large in volume. The computerised accounting system can store and process such voluminous transactions with speed and accuracy.

ii. **Scalability :** A computerised accounting system is scalable to handle the growing transactions.

iii. **Security :** The accounting data under the computerised environment is safer than the accounting data under the manual system. The data can be kept secure by using a password, *i.e.,* allowing only authorised users to access the data.

iv. **Timely Reporting :** Availability of reports on time enables the management to take quick decisions, which is an important element for the success of an enterprise. A computerised accounting system makes these reports available as and when required.

v. **Lower Cost :** The cost of maintaining books of accounts under the computerised process is lower than in comparison to the manual process.

vi. **Less Paper Work :** Under the computerised process, there is less paper work as compared to the paper work in the manual process.

vii. **Flexible Reporting :** Reporting under the computerised process is flexible in comparison to the manual process. The database can be processed further to obtain the desired report. For example, data relating to debtors can be analysed to ascertain the list of customers to whom sales above Rs. 1,00,000 has been made in an accounting year or of the regular customers of the enterprises and so on.

viii. **Queries :** Replies to queries based on external factors can be obtained easily under a computerised process. For example, list of debtors who have not paid on time can be taken out by processing the database.

ix. **Accurate :** Computer statements are far more accurate in comparison to manual statements.

x. **Updating :** Updating and treatment of wrong transactions are easily done.

xi. **Financial Statements :** From the day book, the Voucher Posting software can manage the General Ledger, Trial Balance and Balance Sheet.

13.9 LIMITATIONS OF COMPUTERISED ACCOUNTING SYSTEM

However, computerised accounting suffers from the following limitations :

i. **Controls :** If adequate controls are not built and, where build, are not followed, it can lead to loss of data. It is important to take back-ups at regular intervals to avoid such a situation.

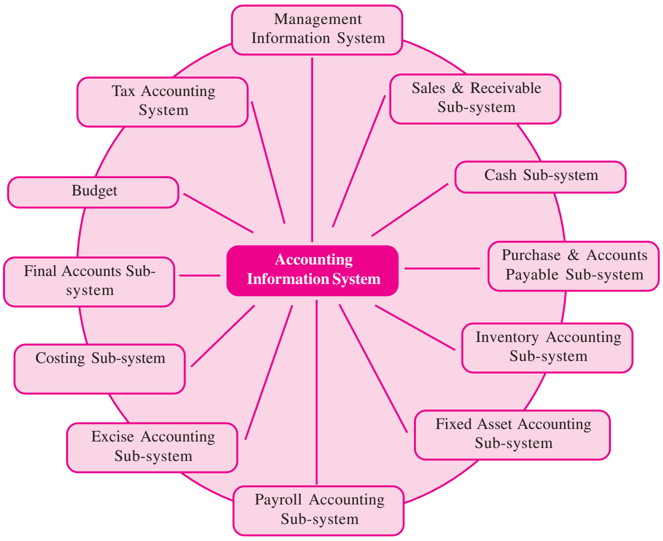
ii. **Data Corruption :** The data can get corrupted through viruses that may come in through the internet or the use of external input devices without scanning them for viruses.

iii. **Trained Computer Operators :** Untrained computer operators can lead to loss of data.

iv. **Limitations of Software :** The software is developed on the basis of the experiences of the team of developers. As such, it may not be able to deal with a specific problem that may arise.

13.10 ACCOUNTING INFORMATION SYSTEM (AIS)

Accounting Information System (AIS) and its various sub-systems may be implemented through Computerised Accounting System. The subsystems of AIS are briefly described:



i. **Cash and Bank Sub-System :** It deals with the receipt and payment of cash both physical cash and electronic fund transfer. Electronic fund transfer takes place without having the physical entry or exit of cash by using the credit cards or electronic banking.

ii. **Sales and Accounts Receivable Sub-system :** It deals with recording of sales, maintaining of sales ledger and receivables. It generates periodic reports about sales, collections made overdue accounts and receivables position as also ageing schedule or receivables/debtors.

iii. **Inventory Sub-system :** It deals with the recording of different items purchased and issued specifying the price, quantity and date. It generates the inventory position and valuation report.

iv. **Purchase and Accounts Payable Sub-system :** It deals with the purchase and payments to creditors. It provides for ordering of goods, sorting of purchase expenses and payment to the creditors. It also generates periodic reports about the performance of suppliers, payment schedule and position of the creditors.

v. **Payroll Accounting Sub-system :** It deals with payment of wages and salary to employees. A typical wage report details information about basic pay, dearness allowance, and other allowances and deductions from salary and wages on account of provident fund, taxes, loans, advances and other charges. The system generates reports about wage bill, overtime payment and payment on account of leave encashment, etc.

vi. **Fixed Assets Accounting Sub-system :** It deals with the recording of purchases, additions, deletions, usage of fixed assets such as land and buildings, machinery and equipments, etc. it also generates reports about the cost, depreciation, and book value of different assets.

vii. **Expense Accounting Sub-system :** This sub-system records expenses under broad groups such as manufacturing administrative, financial, selling and distributions and others.

viii. **Tax Accounting Sub-system :** This sub-system deals with compliance requirement value-added tax (VAT), excise, customs and income tax. This sub-system is used in large size organisation.

ix. **Final Accounts Sub-system :** This subsystem deals with the preparation of Profit and Loss accounts, Balance Sheet and cash flow statements for reporting purposes.

x. **Costing Sub-system :** It deals with the ascertainment of cost of goods produced. It has linkages with other accounting sub-systems for obtaining the necessary information about cost of material, labour, and other expenses. This system generates information about changes in the cost that takes place during the period under review.

xi. **Budget Sub-system :** It deals with the preparation of budget for the coming financial year as well as comparison with the current budget of the actual performances.

xii. **Management Information System :** Management Information System (MIS) deals with generation and processing of reports that are vital for management decision-making. The Information system should be so flexible as to provide

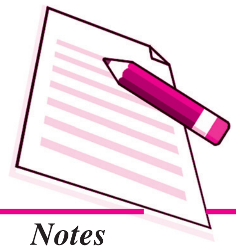
customised reports to support various managerial functions such as planning, organising, staffing, oversight, control and decision-making including operational, functional and strategic nature.

On the basis of the discussions, these are the following differences between manual accounting and computerised accounting.

13.11 COMPARISON OF THE MANUAL AND COMPUTER-ISED ACCOUNTING SYSTEMS

Accounting is a process of identifying, recording, classifying and summarising financial transactions to produce financial statements. Let us discuss the processes of under the two accounting processes, *i.e.*, manual process and computerised process, for the purpose of comparison.

- **Identifying Financial Transactions :** Identifying Financial Transactions and recording them in the books of accounts by applying the principle of accounting is a manual process carried out by an authorised person or on the basis of the accounting manual. This process is, thus, common under both the processes.
- **Recording :** The process of Recording transaction in the books of original entry, posting them in the ledger accounts, performing mathematical functions, *i.e.,* adding, subtraction and totalling, are carried out manually under the manual process. In the computerised process, transactions are recorded in the books of accounts and the remaining functions are performed without any further process or command being carried out manually.
- **Classification :** In the manual process, the transactions are recorded in the book of original entry and are posted into the ledger accounts. It means that, after recording the transaction, another process of posting process is carried out by internal sorting of data, *i.e.,* with the help of utility or application software, without any further process.
- **Summarising :** In the manual system of accounting, the data under each Ledger is summarised and a balance of each account is ascertained to prepare a Trial Balance. As a result, preparing ledger accounts is essential to prepare a Trial Balance. In the computerised process, a transaction or event, once recorded, is stored in the database and can be processed to produce a Trial Balance directly.
- **Adjustments Entries :** Adjustment Entries are passed to rectify an error or to follow the matching concept of accounting, *i.e.,* matching the cost with revenue, The process of passing adjustment entries can be equated with the recording process. These entries are identified and recorded in the books of accounts. The remaining process is the same as discussed above.



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- **Grouping of Accounts :** One of the basics of correct accounting is determining whether a transaction is capital or revenue in nature and, accordingly, which account head is to be debited or credited. Once this decision is taken, the account is grouped as an asset, a liability, an income or an expense at the time of preparing the financial statements. The above process is followed when the manual system of accounting is adopted. However, in computerised accounting, whether an account head is an asset, a liability, an income or an expense, is decided at the time the transaction takes place, as in the case of manual accounting. It is also defined whether the particular head of account shall be shown as an asset or liability, or an income or expense.

- **Financial Statements :** In the manual process, availability of the Trial Balance is essential to prepare the Financial Statements. In the computerised process, financial statements are generated from the system itself and, hence, there is no need to have a Trial Balance.

Difference between Manual Accounting and Computerised Accounting

Point of Difference	*Manual Accounting*	*Computerised Accounting*
1. Recording	Recording of financial transactions is through books of original entry.	Data content of these transactions is stored in well designed data base.
2. Classification	Transactions recorded in the books of original entry are further classified by posting them into ledger accounts. This results in transaction data duplicity.	No such data duplications is made. In order to produce ledger accounts the stored transaction data is processed to appear as classified so that same is presented in the form of report.
3. Summarising	Transactions are summarised to produce trial balance by ascertaining the balances of various accounts.	The generation of ledger accounts is not necessary condition for trial balance.
4. Adjusting entries	Adjusting entries are made to adhere the principle of matching.	There is nothing like making adjusting entries for errors and rectifications.
5. Financial statements	The preparation of financial statements assumes the availability of trial balance.	The preparation of financial statements is independent of producing the trial balance.

13.12 ACCOUNTING SOFTWARES

Accounting Software can be categorised into :

1. **Readymade Software :** Readymade Softwares are the softwares that are developed not for any specific user but for the users in general. Since, the readymade softwares are for general user, it is not necessary that all the modules of such softwares are of use for every user. It is likely that a particular module say 'Payroll' may not be used because the enterprise has very few employees. Similarly, a service enterprise will not require VAT module while a retail enterprise will not require Service Tax module. Some of the Readymade Software available are Tally, Ex, Busy and Professional Accountant. Out of these, Tally is very widely used.

   Readymade Software has its own advantages and disadvantages. *The advantages are :*

   i. **Readymade Softwares are economical :** Readymade Software are prepared not for particular user but for the user in general. It means development cost of the software is not loaded on a single software for determining the cost and thus selling price. The price of the software is determined on the basis of number of pieces expected to be sold. On the other hand, user specific softwares are expensive as the development cost is loaded on one software.

   ii. **Readymade Software are Available off-the-shelf :** It therefore, saves time that may be required for development of tailor-made softwares or for customisation. Development of a software consumes considerable time both at the user end and software development end. User will have to explain its requirements to software developer who on the basis of his understanding will develop software, test it with a dummy data, debug the software to the best of his understanding before handing it to the user. All these activities consume time. On the other hand, Readymade Software requires only installation and are ready for use.

   iii. **Readymade Software are Development by a Group of Experienced Professionals :** It therefore, addresses the problem that may get overlooked if the user specific software is developed.

   iv. **Software Like Any Other Product, Requires Maintenance :** Readymade Softwares being sold to a number of users, has better and economical after sales maintenance service. After sales maintenance service, in the case of user specific softwares will not only be expensive but time consuming as well.

v. **Readymade Softwares are Used by a Number of Users :** Therefore, trained accounting persons are easily available. On the other hand, in the case of tailormade softwares, every time a new person is recruited, training will have to be imported.

The disadvantages of Readymade Softwares are :

i. Readymade Softwares are Window-based softwares, which support only Laserjet printers for-outputs in physical form (printout). Printing by laserjet printers is more expensive than Dot-Matrix printers.

ii. Normally, Readymade Softwares do not have the facility of secondary back-up. It means, in case of data loss, the entire data may not be recovered. But, this limitation can be overcome by taking regular back-up of accounting data.

2. **Customised Software :** The term Customised Software means making changes in the readymade software to suit the specific requirements of the user, *i.e.,* making it user-specific. The software available off-the-shelf is modified to suit the requirements of the user. For example, the design of the invoice is changed to specifications of the user. The developer, to meet specific user requirements, can modify all the readymade softwares. However, the user has to bear the cost of such changes. The advantages and disadvantages of readymade software are also the advantages of Customised Software.

3. **Tailor-made Software :** The term Tailor-made Software refers to designing and developing user-specific software. These softwares, being user-specific, are not available off-the-shelf but are developed to meet the requirement of the user on the basis of discussion between the user and developers.

Advantages of Tailor-made Software are :

i. It, being user specific, takes care of the accounting reports and MIS that may be required by the user and the management of the enterprise.

ii. The software being tailor-made, the enterprise may have to engage a software engineer to maintain it. In other words, the problem faced can be countered immediately.

iii. Well-trained users use the softwares and, therefore, they can maximise software utilization.

Disadvantages of Tailor-made Software are :

i. The development cost of the software is much higher than the cost of readymade or customised software.

ii. In case the accounting person leaves the job, it takes some time before the new person becomes fully conversant with the software.

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iii. Development and maintenance costs are higher than in the case of readymade or customised software.

13.13 FACTORS AFFECTING THE DECISION OF SELECTION AN ACCOUNTING SOFTWARE

It is essential to consider some factors before Sourcing an Accounting Software, *i.e.,*

i. **Flexibility :** A computerized accounting system must be flexible in respect of data entry, retrieval of data and generating designs of report. The user should be able to run the software on a variety of computer environments and machines, that is, on any configuration of computers and available operating systems.

ii. **Cost of Installation and Maintenance :** It is a must to consider that the cost of the accounting software, its relevant hardware and the maintenance, cost of addition of dodules, training of staff, updating of versions and data recovery in case of data failure are negotiable and within the ability of the organization to afford it.

iii. **Size of Organization :** An accounting system must be according to the size of the organization, *i.e.,* volume of business transactions, multi-user requirements.

iv. **Ease of Adaptation and Training Needs :** Some accounting softwares are user-friendly and require a simple training to the users. However, some other complex software packages, linked to other information systems, require intensive training on a continuous basis. The software must be capable of attracting users.

v. **Expected Level of Secrecy (Software and Data) :** Security features of an accounting system software are also important. Software should ensure that it prevents unauthorized access and manipulation of data. In tailored software, the user rights may be restricted according to the departments and their relevant accounting software functions.

vi. **Exporting/Importing Data Facility :** The software should allow easy data transfer option for flexible reporting, such as transfer of information directly from the ledger into the spreadsheet software like Lotus or Excel.

13.14 COMPUTERISED ACCOUNTING

Transaction processing system (TPS) is the first stage of computerised accounting system. The purpose of any TPS is to record, process, validate and store transactions that occur in various functional areas of a business for subsequent retrieval and usage. TPS involves following steps in processing a transaction: Data Entry, Data Validation, Processing and Revalidation, Storage, Information and Reporting.

It is one of the transaction processing systems which is concerned with financial transactions only. When a system contains only human resources it is called manual

Notes

system; when it uses only computer resources, it is called computerised system and when it uses both human and computer resources, it is called computer-based system.

These steps can be explained with an example making use of AutomatedTeller Machine (ATM) facility by a Bank-Customer.

1. **Data Entry :** Processing presumes data entry. A bank customer operates an ATM facility to make a withdrawal. The actions taken by the customer constitute data which is processed after validation by the computerised personal banking system.

2. **Data Validation :** It ensures the accuracy and reliability of input data by comparing the same with some predefined standards or known data. This validation is made by the 'Error Detection' and 'Error Correction' procedures. The control mechanism, wherein actual input data is compared with predetermined norm is meant to detect errors while error correction procedures make suggestions for entering correct data input. The Personal Identification Number (PIN) of the customer is validated with the known data. If it is incorrect, a suggestion is made to indicate the PIN is invalid. Once the PIN is validated, the amount of withdrawal being made is also checked to ensure that it does not exceed a pre-specified limit of withdrawal.

3. **Processing and Revalidation :** The processing of data occurs almost instantaneously in case of Online Transaction Processing (OLTP) provided a valid data has been fed to the system. This is called check input validity. Revalidation occurs to ensure that the transaction in terms of delivery of money by ATM has been duly completed. This is called check output validity.

4. **Storage :** Processed actions, as described above, result into financial transaction data i.e. withdrawal of money by a particular customer, are stored in transaction database of computerized personal banking system. This makes it absolutely clear that only valid transactions are stored in the database.

5. **Information :** The stored data is processed making use of the Query facility to produce desired information.

6. **Reporting :** Reports can be prepared on the basis of the required information content according to the decision usefulness of the report.

INTEXT QUESTIONS 13.2

Fill in the blanks with correct word/words :

i. Computer hardware and .... need to be updated from time to time.

ii. The .... cannot make a decision itself like human beings.

iii. .... requires a neat, clean and controlled temperature to work efficiently.

iv. The most popular system of recording of accounting transactions is ....

v. The computerised accounting uses the concept of ....

vi. Accounting .... is used to implement a computerised accounting.

13.15 NEED AND REQUIREMENTS OF COMPUTERSIED ACCOUNTING

The need for computerised accounting arises from advantages of speed, accuracy and lower cost of handling the business transactions.

- **Numerous Transactions :** The computerised accounting system is capable of handling large number of transactions with speed and accuracy.
- **Instant Reporting :** The computerised accounting system is capable of offering quick and quality reporting because of its speed and accuracy.
- **Reduction in Paper Work :** A manual accounting system requires large physical storage space to keep accounting records/books and vouchers/ documents. The requirement of stationery and books of accounts along with vouchers and documents is directly dependent on the volume of transactions beyond a certain point. There is a dire need to reduce the paper work and dispense with large volumes of books of accounts. This can be achieved by introducing computerised accounting system.
- **Flexible Reporting :** The reporting is flexible in computerised accounting system as compared to manual accounting system. The reports of a manual accounting system reveal balances of accounts on periodic basis while computerised accounting system is capable of generating reports of any balance as when required and for any duration which is within the accounting period.
- **Accounting Queries :** There are accounting queries which are based on some external parameters. For example, a query to identify customers who have not made the payments within the permissible credit period can be easily answered by using the structured query language (SQL) support of database technology in the computerised accounting system. But such an exercise in a manual accounting system is quite difficult and expensive in terms of manpower used. It will still be worse in case the credit period is changed.
- **On-line Facility :** Computerised accounting system offers online facility to store and process transaction data so as to retrieve information to generate and view financial reports.

Notes

- **Scalability :** Computerised accounting system are fully equipped with handling the growing transactions of a fast growing business enterprise. The requirement of additional manpower in Accounts department is restricted to only the data operators for storing additional vouchers. There is absolutely no additional cost of processing additional transaction data.

- **Accuracy :** The information content of reports generated by the computerised accounting system is accurate and therefore quite reliable for decision-making. In a manual accounting system the reports and information are likely to be distorted, inaccurate and therefore cannot be relied upon. It is so because it is being processed by many people, especially when the number of transactions to be processed to produce such information and report is quite large.

- **Security :** Under manual accounting system it is very difficult to secure such information because it is open to inspection by any eyes dealing with the books of accounts. However, in computerised accounting system only the authorised users are permitted to have access to accounting data. Security provided by the computerised accounting system is far superior compared to any security offered by the manual accounting system.

Basic Requirements of the Computerised Accounting System

The basic requirements of any computerised accounting system are the followings:

- **Accounting Framework :** It is the application environment of the computerised accounting system. A healthy accounting framework in terms of accounting principles, coding and grouping structure is a pre-condition for any computerised accounting system.

- **Operating Procedure :** A well-conceived and designed operating procedure blended with suitable operating environment of the enterprise is necessary to work with the computerised accounting system.

The computerised accounting is one of the database-oriented applications wherein the transaction data is stored in well- organized database. The user operates on such database using the required interface and also takes the required reports by suitable transformations of stored data into information. Therefore, the fundamentals of computerised accounting include all the basic requirements of any database-oriented application in computers.

INTEXT QUESTIONS 13.3

I. Fill in the blanks with correct word/words :

i. In a manual accounting system, transactions recorded in the books of ....

ii. The generation of ledger accounts is not a necessary condition for making .... in a computerised accounting system.

iii. The computerised accounting system is capable of handling .... of transactions.

iv. The .... accounting system is capable of offering quick and quality reporting.

v. Computerised accounting system offers .... facility to store transaction data.

vi. Computerised accounting system is .... to the manual accounting system.

vii. The computerised accounting is one of the .... oriented applications

II. Give any two advantages & two limitations of Computerised Accounting System.

III. Define Management Information System.

WHAT YOU HAVE LEARNT

- Computer is an electronic device that can perform a variety of operations in accordance with a set of instructions called programme. It is a fast data processing electronic machine. It can provide solutions to all complicated situations.

- **Characteristics of Computer**
  - Speed
  - Storage
  - Accuracy
  - Diligence
  - Versatility
  - Communication
  - Processing Power

- **Components of Computer**
  - Input Unit
  - Central Processing Unit
    - Control unit
    - Memory unit
    - Arithmetic and logic unit
  - Output unit

- **Limitations of a Computer**
  - Cost of Installation
  - Cost of Training
  - Self-Decision Making
  - Maintenance
  - Dangers for Health

- Salient features of CAS simple & Integrated Transparency and Control Accuracy & Speed Scalability Reliability.
- Accounting Equation is A = L + C
- **Computerised Accounting :** Transaction Processing System (TPS) is the first stage of computerised accounting system.
- **Need for Computerised Accounting**
  - Numerous transactions
  - Instant reporting
  - Reduction in paper work
  - Flexible reporting
  - Online facility
  - Accuracy
  - Security
- Advantages of CAS include speed, efficiency, arithmetic accuracy, cost saving, confidentiality of data.
- Limitation of CAS include provision for (a) fast obsolescence of technology, (b) data loss due to either power interruption or damage to hard disk, (c) virus and other security hazards.
- Accounting Information System is an integration of various sub-systems such as : (i) cash sub-system, (ii) sales and accounts receivable sub-system, (iii) inventory sub-system, (iv) purchase and accounts payable sub-system, (v) payroll accounting sub-system, (vi) fixed asset accounting sub-system, (vii) expense accounting sub-system, (viii) tax accounting sub-system, (ix) final accounts sub-system, (x) costing sub-system, (xi) budget sub-system, (xii) management information sub-system.
- Difference between manual accounting and computerised accounting
  - Recording
  - Classification
  - Summarising
  - Adjusting entries
  - Financial statement

TERMINAL EXERCISE

1. State the meaning and characteristics of Computer.
2. Explain the components of computer.
3. Explain the limitations of a Computer.
4. Explain the role of Computers in Accounting.
5. Differentiate between Manual accounting and Computerised accounting system.
6. Enumerate the basic requirements of any computerised accounting system.

7. Explain the components of Computerised Accounting Software.
8. Describe the salient features of Computerised Accounting Software.
9. How does Computerised Accounting Software ensures data security, safety and confidentiality ? Explain.
10. Explain in brief various softwares of Computerised Accounting Software.
11. Describe any six sub systems of Accounting Informations Systems.

ANSWERS TO INTEXT QUESTIONS

13.1 (i) processing (ii) electrical (iii) tiredness
(iv) communication (v) mouse (vi) brain (vii) monitor

13.2 (i) software (ii) computer (iii) computer
(iv) manual (v) databases (vi) software

13.3 I. (i) original entry (ii) trial balance (iii) large number
(iv) computerised (v) online (vi) superior
(vii) database

II. a) Limitations of Computer : High cost of installation, High cost of training, Dangers for Health.

b) Components of Computerised Accountancy System : Recording of transactions, Preparation of Trial Balance & Financial statement.

c) 1. Accuracy & Speed 2. Scalability 3. Reliability

d)

Fixed Asset	(i) Land	(ii) Building
Current Asset	(i) Cash	(ii) Debtors
Revenue & surplus	(i) Sales	(ii) Other Incomes

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14

DEPRECIATION

Expenditure on assets of the business like furniture, fixtures and fittings of the shop, motor vans, machines and equipments are neither goods nor expenses of a year. Expenditures of this nature give services to the business for many years and therefore called fixed assets. If the expenditure on the fixed assets is deducted from the profit of any one year, it would be wrong. Since their benefit is enjoyed by the business for more than one years. The correct thing will be to distribute their cost over the years of their useful life to the business. The portion of the cost of fixed assets charged each year as expense is named as depreciation.

In this lesson you will learn about the meaning and methods of charging depreciation and how depreciation is recorded in the books of accounts, together with the preparation of Fixed Assets account.

OBJECTIVES

After studying this lesson you will be able to:

- understand the meaning and concept of depreciation;
- explain the causes of depreciation;
- explain the objectives of depreciation;
- explain the factors affecting depreciation
- learn methods of charging depreciation and
- prepare fixed asset account showing the amount of depreciations charged for every year.

14.1 MEANING OF DEPRECIATION

You already know the meaning of terms assets and liabilities. Assets are broadly divided into two categories- current assets (cash, debtors or customers balances, stock of materials and goods) and fixed assets (buildings, furniture and fixtures, machinery and plant, motor vehicles).

Fixed assets are also called long term assets as they provide benefits to the business for more than one year. Most fixed assets lose their value over time as these are put in use and as the years pass by. The fixed assets lose their usefulness due to arrival of new technologies and change of fashions etc. These are then generally required to be replaced, as their useful life is over. Hence, the cost of a fixed asset is allocated over its useful life. Each year's allocation of the cost is charged as depreciation expense for that year.

For example an office chair is purchased for ₹ 2,500 and it is estimated that after ten years it will be scraped. The useful life of the chair is ten years over which the cost of ₹ 2,500 will be distributed. Each year's allocation may be calculated as ₹ 250.

Thus, ₹ 250 is the depreciation expense for each year.

Depreciation, thus, is an expense charged during a year for the reduction in the value of fixed assets, arising due to:

- Normal wear and tear out of its use and passage of time
- Obsolescence due to change in technology, fashion, taste and other market conditions

14.2 CAUSES OF DEPRECIATION

Following are the causes for which depreciation is provided :

i) Normal wear and tear

(a) Due to usage - Every asset has a life for which it can run, produce or give service. Thus, as we put the asset to use its worth decreases. Like decrease in the efficiency and functioning of a bicycle due to its running and usage.

(b) Due to passage of Time – As the time goes by elements of nature, wind, sun, rain etc, cause physical deterioration in the worth of an asset. Like reduction in the worth of a piece of furniture due to passage of time even when it is not used.

ii) Obsolescence

(a) Due to development of improved or superior equipment : Sometimes fixed assets are required to be discarded before they are actually worn out due to either of the above reasons. Arrival of superior equipments and machines etc.

allow production of goods at lower cost. This makes older equipments worthless as production of goods with their use will be costlier and non competitive. For example, Steam engines became obsolete with the arrival of diesel and electric locomotives.

(b) Due to change in fashion, style, taste or market conditions : Obsolescence may also result due to decline in demand for certain goods and services with a change in fashion, style, taste or market conditions. The goods and services that are no longer in vogue lead to decrease in the value of the assets which were engaged in their production - like factories or machines meant for making old fashioned hats, shoes, furniture etc.

Loss in the value of fixed assets for such reasons is called obsolescence and also charged as depreciation.

14.3 OBJECTIVES OF CHARGING DEPRECIATION

Following are the objectives of charging depreciation of Assets:

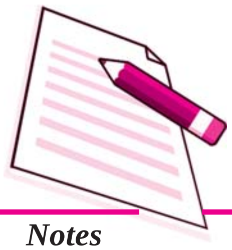
i) **To show the True Financial Position of the Business :** Fixed Assets have some effective working life during which it can be economically operated. Depreciation is the gradual loss in the value of fixed assets. If depreciation is not provided, profit and loss A/c will not disclose the true profit made during the accounting period. At the same time, the Balance Sheet will not disclose the true Financial position as Fixed assets appearing in the Balance Sheet will be over valued. If depreciation in ignored year after year, ultimately when asset is worn out, the proprietor will not be is a position to continue the business smoothly.

ii) **To retain funds in the business for replacement of the asset :** Net profit is the yield of the capital invested by proprietor and may be wholly withdrawn by him in the form of cash. If depreciation is provided, this figure of net profit will be reduced and the amount withdrawn by the proprietor will also be decreased. As such the cash equivalent to the charge for depreciation will be left over in the business. This accumulated amount will enable the proprietor to replace to a new asset.

INTEXT QUESTIONS 14.1

Fill in the blanks :

i. Depreciation represents a __________ in the value of fixed assets.



Notes

ii. Scrap value of an asset means the _________ that it will fetch on sale at the end of its ___________.

iii. Depreciation is calculated as cost of assets less scrap value divided by ___________.

iv. Obsolescence is one of the situations on fixed assets which arises due to change in ________, fashion, taste and other market conditions.

14.4 FACTORS AFFECTING THE DEPRECIATION

Following are the factors that affect the amount of depreciation to be charged on an asset.

i) Cost of Asset : Cost of asset is the purchase price of the asset and includes all such expenses which are incurred before it is first put to use. For example expenses on loading, carriage, installation, transportation and unloading of the asset up to the point of its location, expense on its erection and assembly.

ii) Useful Life of the Asset : Useful life is the expected number of years for which the asset will remain in use.

iii) Scrap Value : Scrap value is the residual value at which the asset could be sold to scrap dealer *(Kabari)* after its useful life.

iv) Depreciable value of asset : Depreciable value is the cost of asset minus the scrap value.

Illustration 1

A generator was purchased for ₹ 5,00,000. ₹ 1,500 was paid for the crane for its loading on the truck, ₹ 7,000 was paid for transporting the generator to the factory. ₹ 2,000 was spent on its unloading at the factory site. The generator was estimated to run for 10 years and thereafter would be saleable for ₹ 60,000. Calculate the depreciable value of the generator.

The cost of the asset is :

Purchase price	₹ 5,00,000
Expenses on Loading	₹ 1,500
Transportation	₹ 7,000
Expenses on unloading	₹ 2,000
Total	**₹ 5,10,500**

The useful life of the generator is 10 years

Notes

Depreciable Value = Cost of Asset - Scrap Value

= ₹ 5,10,500 – ₹ 60,000 = ₹ 4,50,500

14.5 METHOD OF CHARGING DEPRECIATION

Most popularly used methods for charging depreciation are: i. Straight Line Method and ii. Diminishing Balance Method

Straight Line Method of Charging Depreciation

Under this method, the amount of depreciation is uniform from year to year. Suppose, if an asset costs ₹ 1,00,000 and depreciation is fixed @ 10%, then ₹ 10,000 would be written off every year. That is why this method is also called 'Fixed Installment Method' or 'Original Cost Method'. In this method, the amount to be written off every year is arrived at as under:

$$\textbf{Depreciation of Each Year} = \frac{\textbf{Cost of Assets} - \textbf{Estimated Scrap Value}}{\textbf{Number of years of expected life}}$$

Out of the cost of the asset, its scrap value is deducted and it is divided by the number of years of its estimated life.

For example: a machine is purchased for ₹ 1,20,000 and it is estimated that its useful life is 10 years. After its useful life its scrap value is ₹ 20,000. Depreciation of one year can be calculated as under:

$$\textbf{Depreciation of one Year} = \frac{₹\ 1{,}20{,}000 - ₹\ 20{,}000}{₹\ 10} = ₹\ 10{,}000$$

If its scrap can not be sold or no money can be realized from its scrap, then depreciation of one year is:

$$\textbf{Depreciation of one Year} = \frac{₹\ 1{,}20{,}000}{₹\ 10} = ₹\ 12{,}000$$

In this method the amount of depreciation is same for each year. Therefore, this method is called Straight Line Method, Fixed Installment Method or Original Cost Method.

Illustration 2

A machine was purchased on January 1, 2011 for ₹ 1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scraped and nothing will be realized from it. It is decided to charge depreciation on this machine @ 10% p. a. on Straight Line Method.

Calculate amount of depreciation for each year during the useful life of this machine.

Notes

Year	Rate of Depreciation	Amount of Depreciation (₹)
2011	10%	10,000
2012	10%	10,000
2013	10%	10,000
2014	10%	10,000
2015	10%	10,000
2016	10%	10,000
2017	10%	10,000
2018	10%	10,000
2019	10%	10,000
2020	10%	10,000

Amount of depreciation is same every year, so this method is called 'Straight Line Method' or 'Fixed Instalment Method' or 'Original Cost Method'.

Merits of Straight Line Method

i) **Simplicity :** Calculation of depreciation under this method is very simple and therefore, the method is widely popular. Once the amount of depreciation is calculated, the same amount is written off as depreciation each year. Hence, this method is simple and calculations are easier to understand.

ii) **Asset is completely Written Off :** Under this method, the book value of an asset is reduced to net scrap value or zero value. In other words, in the books of accounts the value of the asset at the end of its useful life is equal to zero or its residual value.

Limitations of Straight Line Method

i) **Difficulty in Computation :** When there are various machines having different life-spans, the computation of depreciation becomes complicated because the depreciation on each machine will have to be calculated separately for each asset.

ii) **Illogical :** It is well known that the expense on its repairs and maintenance increases as the asset becomes older. Thus, the total burden on Profit and Loss Account,

depreciation plus repair expenses, is more in later years in comparison to earlier years. This is illogical because the efficiency and productivity of the asset is more in earlier years and less in later years.

Illustration 3

X limited purchased a machine on April 1, 2014 for ₹ 1,00,000 whose life was expected to be 10 years. Its estimated scrap value at the end of 10 years was ₹ 10,000. Find the amount of depreciation to be charged to Profit and Loss Account every year. Calculate the rate on which depreciation is to be charged every year.

Solution

In this question the information available is as under: The amount of depreciation that will be charged to Profit and Loss Account will be calculated as :

(i) Calculation of amount of depreciation

$$\text{Annual Depreciation} = \frac{\text{Cost of Machine} - \text{Estimated Scrap Value}}{\text{Expected Life of the Asset}}$$

$$= \frac{₹\ 1,00,000 - ₹\ 10,000}{10} = ₹\ 9,000$$

(ii) Calculation of Rate of Depreciation

$$\text{Rate of Depreciation} = \frac{\text{Annual Depreciation Amount X 100}}{\text{Cost of Asset}}$$

$$= \frac{₹\ 9,000 \text{ X } 100}{₹\ 1,00,000} = 9\%$$

Illustration 4

Salman and Usman Bros. acquired a machine on July 1, 2014 at a cost of ₹ 70,000 and spent ₹ 5,000 on its installation. The firm writes off depreciation @ 10% on straight line method. The books are closed on December 31 every year. Show the machinery and depreciation account for three years.

Solution

Cost of Machine	₹ 70,000
Cost of Installation	₹ 5,000
Total	₹ 75,000
Rate of Depreciation	10%.

Then annual depreciation will be 10% of 75000 = ₹ 7,500.

Notes

Dr. **Depreciation Account** Cr.

Date	*Particulars*	*J.F.*	*Amount*	*Date*	*Particulars*	*J.F.*	*Amount*
2014				**2014**			
Dec. 31	To Machinery A/c		3,750	Dec.31	By P & L A/c		3,750
2015				**2015**			
Dec. 31	To Machinery A/c		7,500	Dec.31	By P & L A/c		7,500
2016				**2016**			
Dec. 31	To Machinery A/c		7,500	Dec.31	By P & L A/c		7,500

Dr. **Machinery Account** Cr.

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2014				**2014**			
July 01	To Bank A/c		70,000	Dec. 31	By Depreciation A/c $7000\times\frac{10}{100}\times\frac{6}{12}$		3,750
July 01	To Bank A/c		5,000	Dec. 31	By Balance c/d		71,250
			75,000				75,000
2015				**2015**			
Jan. 01	To Balance b/d		71,250	Dec. 31	By Depreciation A/c $75000\times\frac{10}{100}$		7,500
					By Balance c/d		63,750
			71,250				71,250
2016				**2016**			
Jan. 01	To Balance b/d		63,750	Dec. 31	By Depreciation A/c $75000\times\frac{10}{100}$		7,500
				Dec. 31	By Balance c/d		56,250
			63,750				63,750

Illustration 5

On April 1, 2014, a company purchased machinery worth ₹ 1,00,000 . On October 1, 2016, it purchased additional machinery worth ₹ 20,000 and spent ₹ 2,000 on its erection. The accounts are closed each year on March 31. Assuming the annual depreciation to be 10%, show the Machinery Account for 5 years under the straight line method.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2014				**2015**			
Apr. 01	To Bank A/c		1,00,000	Mar. 31	By Depreciation A/c		10,000
					$1,00,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		90,000
			1,00,000				1,00,000
2015				**2016**			
Apr. 1	To Balance b/d		90,000	Mar. 31	By Depreciation A/c		10,000
					$1,00,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		80,000
			90,000				90,000
2016				**2017**			
Apr. 1	To Balance b/d		80,000	Mar. 31	By Depreciation A/c		11,100
Oct. 1	To Bank A/c		20,000		$1,00,000 \times \frac{10}{100}$		
	To Bank A/c		2,000		$22,000 \times \frac{10}{100} \times \frac{6}{12}$		
				Mar. 31	By Balance c/d		90,900
			1,02,000				1,02,000
2017				**2018**			
Apr. 1	To Balance b/d		90,900	Mar. 31	By Depreciation A/c		12,200
					$1,00,000 \times \frac{10}{100}$		
					$22,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		78,700
			90,900				90,900
2018				**2019**			
Apr. 1	To Balance b/d		78,700	Mar. 31	By Depreciation A/c		12,200
					$1,00,000 \times \frac{10}{100}$		
					$22,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		66,500
			78,000				78,700
2019							
Apr. 1	To Balance b/d		66,500				

Notes

Illustration 6

On 1st January, 2014 a Company purchased a plant for ₹ 20,000. On 1st July in the same year, it purchased additional plant worth ₹ 8,000 and spent ₹ 2,000 on its erection. On 1st July, 2015, the plant purchased on 1st jan., 2014 having become obsolete, was sold off for ₹ 12,500. On 1st October, 2016, fresh plant was purchased for ₹ 28,000 and on the same date, the plant purchased on 1st July, 2014 was sold at ₹ 6,000.

Depreciation is provided at 10% per annum on original cost on 31st December every year. Show the plant account for 2014 to 2016.

Solution

Dr. **Plant Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2014				**2014**			
Jan. 01	To Cash A/c		20,000	Dec. 31	By Depreciation A/c		
July 01	To Cash A/c		8,000		(i) for a year 2,000		
	To Cash A/c				(ii) for six months 500		2,500
	(expenses)		2,000		By Balance c/d		
					(i) 18,000		
					(ii) 9,500		27,500
			30,000				30,000
2015				**2015**			
Jan. 1	To Balanc b/d			July 1	By Cash A/c (sale)		12,500
	(i) 18,000			Dec. 31	By Depreciation A/c (i)		1,000[1]
	(ii) 9,500		27,500		By Profit & Loss A/c		4,500[1]
				Dec. 31	By Depreciation A/c (ii)		1,000
				Dec. 31	By Balance c/d		
					(₹ 9,500 - ₹ 1,000)		8,500
			27,500				27,500
2016				**2016**			
Jan. 1	To Balance b/d (ii)		8,500	Oct. 1	By Cash A/c (sale)		6,000
Oct. 1	To Cash A/c (iii)		28,000	Oct. 1	By Depreciation A/c (ii)		750[2]
				Oct. 1	By Profit & Loss A/c (loss)		1,750
				Dec. 31	By Depreciation A/c (iii)		
					(28,000 x 10/100 x 3/12)		700
				Dec. 31	By Balance c/d		
					(₹ 28,000 - ₹ 700)		27,300
			36,500				36,500

Note : Calculation of loss on sale of plant :

		₹
(i)	On 1-1-2015 book value of the plant sold [Plant (i)]	18,000
	Less : Depreciation for 6 months *i.e.* 20,000 x 10/100 x 6/12	1,000

	On 1-7-2015 book value of plant sold	17,000
	Less : Sale price of plant	12,500
	Loss on sale of plant	4,500
(ii)	On 1-1-2016 book value of plant sold [Plant (ii)]	8,500
	Less : Depreciation for 9 months is 10,000 x 10/100 x 9/12	750
	On 1-10-2016 book value of plant sold	7,750
	Less : Sale Price	6,000
	Loss on Sale of Plant	1,750

INTEXT QUESTIONS 14.2

Fill in the blanks :

i. The assumption underlying the fixed installment method of depreciation is that the amount of the fixed assets over different years of its useful life remains the __________.

ii. Straight line method of charging depreciation is also known as __________ or _________.

iii. Under straight line method the value of the assets at the end of its useful life is equal to ___________ or its ____________.

iv. Under straight line method the total burden on Profit and Loss Account in comparision to earlier years is ______________.

(2) Diminishing Balance Method

Under this method, as the value of asset goes on diminishing year after year, the amount of depreciation charged every year goes on declining. The amount of depreciation is calculated as a fixed percentage of the diminishing value of the asset shown in the books at the beginning of each year. Under this method the value of an asset never comes to zero.

Suppose, the cost of the asset is ₹ 40,000 and the percentage to be written off each year is 10%. In the first year the amount of the depreciation will be ₹ 4,000 i.e., 10% of ₹ 40,000. This will reduce the book value to ₹ 36,000 i.e. ₹ 40,000 – ₹ 4,000. Now, at the beginning of the next year the book value is ₹ 36,000. The amount of the depreciation for the next year will be ₹ 3,600, i.e., 10% of ₹ 36,000. Thus, every year the amount of the depreciation will go on reducing. This method of charging depreciation is also known as Reducing Balance Method or written down value method.

Notes

Illustration 7

A machine was purchased on January 1, 2014 for ₹ 1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scraped and ₹ 4,000 will be realized from it. It is decided to charge depreciation on this machine @ 10% p. a. on Diminishing Balance Method.

Calculate amount of depreciation for each year during the useful life of this machine.

Solution

Year	Rate of Depreciation	Amount of Depreciation
2014	10%	10,000
2015	10%	9,000
2016	10%	8,100
2017	10%	7,290
2018	10%	6,561
2019	10%	5,905
2020	10%	5,314
2021	10%	4,783
2022	10%	4,305
2023	10%	3,874

Amount of depreciation is decreased year after year in this method that is why this method is called 'Diminishing Balance Method' or 'Reducing balance method' or 'written down value method'.

Merits of Diminishing Balance Method

Equal Burden on Profit & Loss Account

During the initial years the productivity of the asset is more hence its contribution to profit is also relatively greater. Therefore, the cost charged in terms of depreciation should also be greater.

In the initial year, the depreciation charges are more and repair expenses are less. In later years, depreciation charges are less and repair expenses are more. Hence the total burden of depreciation plus repair expenses, is some what equal on Profit & Loss Account for each year.

Demerits of Diminishing Balance Method

i) **Asset cannot be completely written off :** Under this method, the value of an asset is not reduced to zero even when there is no scrap value.

ii) **Complexity :** Under this method, the rate of depreciation cannot be determined easily.

INTEXT QUESTIONS 14.3

Fill in the blanks with suitable words

i. Depreciation represents a ________ in the value of fixed assets.

ii. The amount of depreciation on machinery is credited to ______ account.

iii. Depreciation is calculated on _______ under the straight line method.

iv. Depreciation is calculated on ________ under the diminishing balance method.

v. The value of an asset is not reduced to ________ even when there is no scrap value in diminishing balance method of depreciation.

Illustration 8

Widson enterprise purchased Plant and Machinery for ₹ 1,00,000 on 1st October 2012. It decided to write off depreciation 20% per annum on Written Down Value Method. On 1st January, 2015 purchased additional Machinery for ₹ 40,000.

Show Machinery Account upto the year ending 31st March, 2016. The accounting year ends on 31st March.

Solution

Dr. **Plant and Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2012 Oct. 01	To Bank		1,00,000	**2013** Mar. 31	By Depreciation (for six months)		10,000
					By Balance c/d		90,000
			1,00,000				1,00,000
2013 Apr. 01	To Balance b/d		90,000	**2014** Mar. 31	By Depreciation (on ₹ 90,000 for one year)		18,000
					By Balance c/d		72,000
			90,000				90,000

Notes

2014				**2015**			
Apr. 01	To Balance b/d		72,000	Mar. 31	By Depreciation (On ₹ 72,000) for one year ₹ 14,400 On ₹ 40,000 for 3 months ₹ 2,000		16,400
2015							
Jan. 01	To Bank		40,000		By Balance c/d		95,600
			1,12,000				1,12,000
2015				**2016**			
Apr. 01	To Balance b/d		95,600	Mar. 31	By Depreciation (On ₹ 95,600 for one year)		19,120
					By Balance c/d		76,480
			95,600				95,600
2016							
Apr. 01	To Balance b/d		76,480				

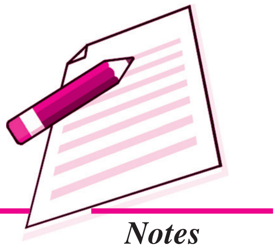
Illustration 9

On April 1, 2014 Ganga Bros. purchased two machines for ₹ 75,000 each. Depreciation at the rate of 10% on diminishing balance method was provided. On March 31, 2016, one machine was sold for ₹ 55,000. An improved model with a cost of ₹ 80,000 was purchased on the same day. You are required to show the Machinery Account for 2014-15 to 2015-16. The accounting year ends on 31st March.

Solution

Dr. **Machinery Account** **Cr.**

Date	*Particulars*	*J.F.*	₹	*Date*	*Particulars*	*J.F.*	₹
2014				**2015**			
Apr. 01	To Bank		1,50,000	Mar. 31	By Depreciation A/c		15,000
				Mar. 31	By Balance c/d		1,35,000
			1,50,000				1,50,000
2015				**2016**			
Apr. 01	To Balance b/d		1,35,000	Mar. 31	By Depreciation A/c		13,500
2016							
Mar. 31	To Bank A/c		80,000	Mar. 31	By Bank A/c		55,000
					By P & L A/c		5,750
					By Balance c/d		1,40,750
			2,15,000				2,15,000
2016							
Apr. 01	To Balance b/d		1,40,750				



Notes

Note : Calculation of loss on sale of machine :

Initial Cost	75,000
Dep. in 2015	- 7,500
Book Value in 2015	67,500
Dep. in 2016	- 6,750
Book Value in 2016	60,750
Sale Price	- 55,000
Loss on Sale	5,750

Illustration 10

On October 1, 2014, the Akash Transport Company purchased a Truck for ₹ 8,00,000. On April 1, 2016, this Truck was involved in an accident and was completely destroyed and ₹ 6,00,000 were received from Insurance Company in full settlement. On the same date another Truck was purchased by the company for ₹ 10,00,000. The company writes off 20% depreciation p. a. on written down value method. Give the Truck Account from 2014 to 2016. The accounting year ends on 31st December.

Solution

Dr. **Truck Account** **Cr.**

Date	*Particulars*	*J.F.*	*₹*	*Date*	*Particulars*	*J.F.*	*₹*
2014				**2014**			
Oct. 01	To Bank A/c		8,00,000	Dec. 31	By Depreciation A/c $8{,}00{,}000 \times \frac{20}{100} \times \frac{3}{12}$		40,000
				Dec. 31	By Balance c/d		7,60,000
			8,00,000				8,00,000
2015				**2015**			
Jan. 01	To Balance b/d		7,60,000	Dec. 31	By Depreciation A/c $7{,}60{,}000 \times \frac{20}{100}$		1,52,000
				Dec. 31	By Balance c/d		6,08,000
			7,60,000				7,60,000

2016				2016			
Jan. 01	Balance b/d		6,08,000	Apr. 01	By Bank A/c		6,00,000
Apr. 01	To P & L A/c		22,400	Apr. 01	By Depreciation A/c $6,08,000\times\frac{20}{100}\times\frac{3}{12}$		30,400
Apr. 01	To Bank A/c		10,00,000	Dec. 31	By Depreciation A/c $10,00,000\times\frac{20}{100}\times\frac{9}{12}$		1,50,000
				Dec. 31	By Balance c/d		8,50,000
			16,30,400				**16,30,400**

Distinction between Straight Line Method and Diminishing Balance Method

Basis	*Straight Line Method*	*Diminishing Balance Method*
Basis of Calculation	Depreciation is calculated on original cost of the asset.	Depreciation is calculated on original cost in first year and on written down value of the asset in subsequent years.
Amount of Depreciation	The amount of depreciation remains the same for all years.	The amount of depreciation goes on reducing year after year.
Value of Asset	The book value of the asset can be reduced to zero.	The book value of the asset can never be reduced to zero.
Depreciation and Repairs	The combined cost on account of depreciation and repairs is lower in the initial years and higher in the later years.	The combined cost on account of depreciation and repairs remains, more or less, equal throughout the period.

INTEXT QUESTIONS 14.4

I. State which of the following statements are true and which are false:

i. Amount of depreciation goes on reducing year after year in Straight Line Method.

ii. The amount of depreciation remains the same for all years in Diminishing Balance Method.

iii. The book value of the asset can be reduced to zero in Straight Line Method.

iv. The book value of the asset can never be reduced to zero in Diminishing Balance Method.

II. Multiple Choice Questions

i. Depreciation is charged on :

a) Stock of Goods b) Current Assets

c) Fixed Assets d) Liquid Assets

ii. Obsolescence term is due to :

a) Tear and wear of the Assets

b) Decrease in the value of the assets which are engaged in production

c) Development of improved or superior quality of equipment.

d) Due to usage and age of assets

iii. While charging depreciation on Fixed Assets by Straight line method, the value of the asset is taken into consideration is :

a) Original value b) Diminished value

c) Market value d) Book value

iv. While charging depreciation on Fixed assets by Reducing balance method, the value of the asset is taken into consideration is :

a) Original cost b) Diminished value

c) Market value d) Book value

v. The amount calculated for charging depreciation :

a) Includes the amount of scrap value of the Asset

b) Do not include the amount of scrap value of the asset

c) Cost of assets less scrap value

d) None of the above.

vi. Out of the following which is the cause of depreciation:

a) Normal wear and tear b) Scrap value

c) Cost of asset. d) Decrease or increase in market price

vii. Out of the following what will be the amount of annual depreciation :

a) Total Depreciation + installation charges cost

b) Total cost – Scrap value ÷ Expected life

c) Total cost + Scrap value ÷ Expected life

d) None of the above.

viii. Which one of the following is not a factor affecting annual depreciation on an asset.

a) Cost of the Asset   b) Scrap Value of the asset

c) Useful life of the asset   d) Annual maintenance on the asset.

ix. Out of the following on which asset depreciation will be charged :

a) Stock   b) Debtors   c) Machinery   d) Land

x. Out of the following assets on which depreciation will not be charged:

a) Machinery   b) Plant   c) Photo Copier   d) Stock

14.6 ASSET DISPOSAL ACCOUNT

If part of the asset is sold, it is appropriate to open a new account called as 'Assets Disposal Account'. In this case, method of recording the entries will depend on the fact whether :

i. Provision for Depreciation A/c is not maintained.

ii. Provision for Depreciation A/c is maintained.

I. When Provision for Depreciation A/c is not maintained, Journal Entries will be : Under this method depreciation is directly charged to the assets account. Thus, normally only the assets account is prepared.

(i) For Transfer of Book Value of Asset to Asset Disposal A/c

Assets Disposal A/c :   Dr.

To Assets A/c

(ii) For Sale of Asset :

Bank A/c

To Assets Disposal A/c

(iii) For profit on Sale of Asset

Assets Disposal A/c

To Profit & Loss A/c

(iv) For loss on Sale of asset

Profit & Loss A/c

To Assets Disposal A/c

II. When Provision for Depreciation Account is maintained : (Accumulated Depreciation Account) Under this method, depreciation is not directly charged to the asset account. The amount of depreciation to be provided for the period is debited to depreciation account and credited to 'Provision for Depreciation Account' or 'Accumulated Depreciation Account'. Thus, entry will be as follows :

(i) For asset purchased :

Asset A/c Dr.

To Cash/Bank A/c

(ii) For depreciation charged :

Depreciation A/c Dr.

To provision for Depreciation A/c

(iii) For transfer of depreciation to Profit and Loss Account

Profit & Loss A/c Dr.

To Depreciation A/c

In the balance sheet, the asset appears at its original cost and provision for depreciation (or accumulated depreciation) appears on the liabilities side.

As the year passes, the balance of the accumulated depreciation goes on increasing since constant credit is given to this account in each accounting year. After the expiry of useful life, these two accounts are closed by debiting Accumulated Depreciation Account and crediting Asset Account and balance in asset account is transferred to Profit & Loss Account. Entry will be :

Provision for Depreciation A/c Dr.

To Asset A/c

(Balance of Prov. for depreciation to Asset A/c)

Profit & Loss A/c Dr.

To Asset A/c

(For loss on asset)

OR

Asset A/c Dr.

To Profit & Loss A/c

(For profit on asset)

Illustration 11

On January 1, 2012 X Ltd. purchased a machinery by cheque for ₹ 12,00,000. On July 1, 2014 a part of the machinery purchased on January 1, 2012 for ₹ 80,000 was sold for ₹ 45,000 and new machinery at a cost of ₹ 1,58,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation on the original cost of the machinery.

Give journal entries and show the necessary ledger accounts assuming that (i) Provision for Depreciation A/c is not maintained. (ii) Provision for Depreciation Account is maintained. The accounting year ends on 31st December.

Solution

(i) When Provision for Depreciation A/c is not maintained :

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
2012				
Jan. 1	Machinery A/c Dr.		12,00,000	
	To Bank A/c			12,00,000
	(For purchase of machinery)			
Dec. 31	Depreciation A/c Dr.		1,20,000	
	To Machinery A/c			1,20,000
	(For depreciation charged)			
Dec. 31	Profit & Loss A/c Dr.		1,20,000	
	To Depreciation A/c			1,20,000
	(For depreciation transferred to P/L A/c)			
2013				
Dec. 31	Depreciation A/c Dr.		1,20,000	
	To Machinery A/c			1,20,000
	(For depreciation charged)			
Dec. 31	Profit & Loss A/c Dr.		1,20,000	
	To Depreciation A/c			1,20,000
	(For depreciation transferred to P/L A/c)			
2014				
July 1	Depreciation A/c Dr.		4,000	
	To Machinery A/c			4,000
	(For current half yearly depreciation charged on machinery disposed)			

Notes

July 1	Machinery Disposal A/c To Machinery A/c (For transfer to machinery disposal A/c at its book value)	Dr.		60,000	60,000
July 1	Bank A/c To Machinery Disposal A/c (For sale of machine)	Dr.		45,000	45,000
July 1	Machinery A/c To Bank A/c (For purchase of machinery)	Dr.		1,58,000	1,58,000
Dec. 31	Depreciation A/c To Machinery A/c (For depreciation charged on remaining machinery)	Dr.		1,19,900	1,19,900
Dec. 31	Profit & Loss A/c To Depreciation A/c (For depreciation transferred P/L A/c)	Dr.		1,23,900	1,23,900
Dec. 31	Profit & Loss A/c To Machinery Disposal A/c (For Loss on sale of machinery transferred to P/L A/c)	Dr.		15,000	15,000

Machinery Account

		₹			₹
2012			**2012**		
Jan. 1	To Bank A/c	12,00,000	Dec. 31	By Depreciation A/c	1,20,000
			Dec. 31	By Balance c/d	10,80,000
		12,00,000			12,00,000
2013			**2013**		
Jan. 1	To Balanced b/d	10,80,000	Dec. 31	By Depreciation A/c	1,20,000
			Dec. 31	By Balance c/d	9,60,000
		10,80,000			10,80,000
2014			**2014**		
Jan. 1	To Balance b/d	9,60,000	July 1	By Depreciation A/c (on 80,000 for 6 months @10%)	4,000

Notes

July 1	To Bank A/c	1,58,000	July 1	By Machinery Disposal A/c (Rs. 80,000-Rs. 20,000)	60,000
			Dec. 31	By Depreciation A/c	1,19,900[1]
				By Balance c/d	9,34,100
		11,18,000			11,18,000

Machinery Disposal Account

		₹			₹
2013			2014		
July 1	To Machinery A/c	60,000	July 1	By Bank (sale)	45,000
			Dec. 1	By Profit & Loss A/c (loss)	15,000
		60,000			60,000

(ii) Provision for Depreciation A/c is Maintained :

Journal

Date	*Particulars*	*L.F.*	*Dr. (₹)*	*Cr. (₹)*
2012				
Jan. 1	Machinery A/c Dr.		12,00,000	
	To Bank A/c			12,00,000
	(For purchase of machinery)			
Dec. 31	Depreciation A/c Dr.		1,20,000	
	To Provision for Depreciation A/c			1,20,000
	(For depreciation charged)			
Dec. 31	Profit & Loss A/c Dr.		1,20,000	
	To Depreciation A/c			1,20,000
	(For depreciation transferred to Profit & Loss A/c)			
2013				
Dec. 31	Depreciation A/c Dr.		1,20,000	
	To Provision for Depreciation A/c			1,20,000
	(For depreciation charged)			

Dec. 31	Profit & Loss A/c Dr. To Depreciation A/c (For depreciation transferred to Profit & Loss A/c)		1,20,000	1,20,000
2014				
July 1	Machinery Disposal A/c Dr. To Machinery A/c (For transfer to machinery disposal A/c)		80,000	80,000
July 1	Bank A/c Dr. To Machinery Disposal A/c (For sale of machine)		45,000	45,000
July 1	Depreciation A/c Dr. To Provision for Depreciation A/c (for current half yearly depreciation charged on machinery disposed)		4,000	4,000
July 1	Provision for Depreciation A/c Dr. To Machinery Disposal A/c (For transfer accumulated depreciation on machinery sold)		20,000	20,000
July 1	Machinery A/c Dr. To Bank A/c (For purchase of machinery)		1,58,000	1,58,000
Dec. 31	Depreciation A/c Dr. To Provision for Depreciation A/c (For depreciation charged on remaining machinery)		1,19,900	1,19,900
Dec. 31	Profit & Loss A/c Dr. To Depreciation A/c (For depreciation transferred P/L A/c)		1,23,900	1,23,900
Dec. 31	Profit & Loss A/c Dr. To Machinery Disposal A/c (For Loss on sale of machinery transferred to P/L A/c)		15,000	15,000

Notes

Machinery Account

		₹			₹
2012			**2012**		
Jan. 1	To Bank A/c	12,00,000	Dec. 31	By Balance c/d	12,00,000
2013			**2013**		
Jan. 1	To Balance b/d	12,00,000	Dec. 31	By Balance c/d	12,00,000
2014			**2014**		
Jan. 1	To Balance b/d	12,00,000	July 1	By Machinery Disposal A/c	80,000
July 1	To Bank A/c	1,58,000	Dec. 31	By Balance c/d	12,78,000
		13,58,000			13,58,000

Depreciation Account

		₹			₹
2012			**2012**		
Dec. 31	To Provision for Depreciation A/c	1,20,000	Dec. 31	By Profit & Loss A/c	1,20,000
2013			**2013**		
Dec. 31	To Provision for Depreciation A/c	1,20,000	Dec. 31	By Profit & Loss A/c	1,20,000
2014			**2014**		
July 1	To Provision for Depreciation A/c	4,000	Dec. 31	By Profit & Loss A/c	1,23,900
Dec. 31	To Provision for Depreciation A/c	1,19,900			
		1,23,900			1,23,900

Provision for Depreciation Account

		₹			₹
2012			**2012**		
Dec. 31	To Balance c/d	1,20,000	Dec. 31	Depreciation A/c	1,20,000

2013			**2013**		
Dec. 31	To Balance c/d	2,40,000	Jan. 1	By Balance b/d	1,20,000
			Dec. 31	By Depreciation A/c	1,20,000
		2,40,000			2,40,000
2014			**2014**		
Dec. 31	To Machinery Disposal A/c	20,000[1]	Jan. 1	By Balance b/d	2,40,000
Dec. 31	To Balance c/d	3,43,900	July 1	By Depreciation A/c (80,000 x 10/100 x 6/12)	4,000
			Dec. 31	By Depreciation A/c	1,19,900[2]
		3,63,900			3,63,900

Machinery Disposal Account

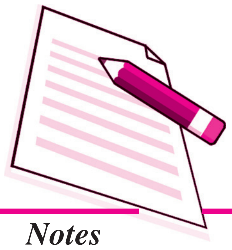
		₹			₹
2014			**2014**		
July 1	To Machinery A/c	80,000	July 1	By Bank A/c (Sale)	45,000
			July 1	By Provision on Depreciation A/c (8,000 + 8,000 + 4,000)	20,000
			Dec.31	By Profit & Loss A/c (loss)	15,000
		80,000			80,000

Note : (1) Calculation of Depreciation on machinery disposed off update :

Depreciation @ 10% on ₹ 80,000 for $2\frac{1}{2}$ year = 20,000.

(2) Calculation of Depreciation on machinery (other than sold)

(i)	On old machine (11,20,000 x 10/100)	1,12,000
(ii)	On new machine (1,58,000 x 10/100 x 6/12)	7,900
		1,19,900



Notes

Illustration 12

On 1st April 2011, X Ltd. purchased a plant for ₹ 5,00,000. On 1st July 2013, a part of plant purchased for ₹ 70,000 on 1st April 2011 was sold for ₹ 40,000 and a fresh plant was purchased for ₹ 1,00,000. Depreciation is provided @20% p.a. on reducing balance method and books of accounts are closed on 31st December each year.

Prepare Plant A/c., Provision for Depreciation A/c and Plant Disposal A/c.

Solution :

Plant Account

		₹			₹
2011			**2011**		
April 1	To Bank A/c	5,00,000	Dec. 31	By Balance c/d	5,00,000
2012			**2012**		
Jan. 1	To Balance b/d	5,00,000	Dec. 31	By Balance c/d	5,00,000
2013			**2013**		
Jan. 1	To Balance b/d	5,00,000	July1	By Plant Disposal A/c	70,000
July 1	To Bank A/c	1,00,000	Dec. 31	By Balance c/d	5,30,000
		6,00,000			6,00,000

Provision for Depreciation Account

		₹			₹
2011			**2011**		
Dec. 31	To Balance c/d	75,000	Dec. 31	By Depreciation A/c	75,000
2012			**2012**		
Dec. 31	To Balance c/d	1,60,000	Jan. 1	By Balance b/d	75,000
			Dec. 31	By Depreciation A/c	85,000
		1,60,000			1,60,000
2013			**2013**		
July 1	To Plant Disposal A/c	27,160[(1)]	Jan. 1	By Balance b/d	1,60,000
			July 1	By Depreciation A/c (Rs. 47,600 for 1/2 year @ 20%)	4,760
July 1	To Balance c/d	2,06,080	Dec. 31	By Depreciation A/c	68,480[(2)]
		2,33,240			2,33,240

Plant Disposal Account

		₹			₹
2011			**2011**		
July 1	To Plant A/c	70,000	July 1	By Bank A/c (sale)	40,000
			July 1	By Prov. for Dep. A/c	27,160[(1)]
			July 1	By P & L A/c (loss)	2,480
		70,000			70,000

Note :

(1) Depreciation on Plant Sold :

Particulars	₹
In 2011 on ₹ 70,000 for 9 months @ 20%	10,500
In 2012 on ₹ 59,500 (₹ 70,000 - ₹ 10,500) for 1 year - @ 20%	11,900
In 2013 on ₹ 47,600 (₹ 59,500 - ₹ 11,900) for 1/2 year @ 20%	4,760
Total	27,160

(2) Depreciation on Plant Retained :

		₹
Total Plant	₹ 5,30,000	
Less : Purchased on July, 2013 for ₹ 1,00,000 for 1/2 year @ 20% =		10,000
Old Plant purchased on		₹ 4,30,000
Plant retained ₹ 4,30,000 - 64,500 - 73,100 =		
	₹ 2,92,400 for 1 year @ 20%	58,480
	Total	68,480

WHAT YOU HAVE LEARNT

- Depreciation is the gradual and permanent decrease in the value of an asset due to efflux of time, wear and tear, obsolescence or any other reason.
- **Causes of Depreciation**
  - Physical Wear and Tear due to usage
  - Physical wear and tear due to passage of time

Notes

- Obsolescence due to advancement in technology

- **Objective of Depreciation**
  - To show the True Financial Position of the business.
  - To retain funds in the business for replacement of the Asset.
- **Methods of Charging Depreciation**
  - Straight Line Method
  - Diminishing Balance Method
- **Merits of Straight Line Method**
  - Simplicity
  - Assets can be Completely Written Off
- **Demerits of Straight Line Method**
  - Difficulty in Computation
  - Illogical
- **Merits of Diminishing Balance Method**
  - Equal burden on Profit & Loss Account.
  - Balance of Asset is never written Off to Zero
- **Demerits of Diminishing Balance Method**
  - Asset cannot be completely written off
  - Complexity

TERMINAL EXERCISE

1. What is depreciation? Write the various objectives of providing depreciation.
2. What are the causes of providing depreciation?
3. What are the two methods of providing depreciation? Explain their merits and demerits.
4. What are the objectives of providing depreciation?
5. Distinguish between Straight Line Method and Diminishing Balance Method of Depreciation.

6. Krishnamohan Limited purchased a machinery on October1, 2008 for ₹ 90,000 and spent ₹ 10,000 on its erection. The depreciation is to be charged @ 10% p. a. on original cost. Show the Machinery Account for three years if books are closed on March 31 every year.

7. On April 1, 2008 Aashi Limited purchased a machinery for ₹ 80,000 and spent ₹ 20,000 on its repairs and installation. On September 30, 2011, the machinery was sold for ₹ 60,000. Prepare Machinery Account for the year 2008 to 2011, if depreciation is charged @ 10% p. a. by Straight Line Method.

8. Ajay Kumar and Company purchased machinery for ₹ 20,000 on April 1, 2007. The Machinery is depreciated at 10% per annum on the straight line method. On October 1, 2010, the machinery was sold for ₹ 8,000.

   Give the Machinery Account if books are closed on March 31 every year.

9. A Plant is purchased for ₹ 80,000 on January 1, 2008. It is estimated that the residual value of the plant at the end of its working life of 10 years will be ₹ 27,894. Depreciation is to be provided at 10% p.a. on diminishing balance method.

   You are required to show the Plant Account for 4 years assuming that the books are closed on March 31 every year.

10. On January 1, 1987 Machinery Account showed a balance of ₹ 10,000. On 1st July, 1988, a new machine costing ₹. 6,000 was purchased. On 30th June, 1990, Machinery other than the machine bought on 1st July, 1988, was disposed off for ₹ 6,000.

    Show the Machinery Account for four years. The accounting year ends on 31st December, and depreciation is to be provided at 10% p.a. on written down value.

11. On 1.1.2010 X Ltd. purchased a machinery of Rs. 2,00,000 and spent ₹ 50,000 on its erection. Depreciation on the machinery was to be charged @ 20% p.a. on straight line method. On 30.6.2012 a piece of machinery included in machinery purchased on 1.1.2010 costing ₹ 20,000 was sold for ₹ 12,000.

    Prepare machinery account, machinery disposal account and provision for depreciation account.

ANSWERS TO INTEXT QUESTIONS

14.1 i) Diminution ii) Amount, life

iii) Life of assets iv) Technology

14.2 i) Same ii) Fixed instalment method, Original cost method

iii) Zero, Net Scrap value iv) More

14.3 i) Fall ii) Machinery iii) Original cost

iv) Opening balance of the year v) Zero

14.4 I. i) False ii) False i ii) True iv) True

II. i) c ii) c iii) a iv) b v) c

vi) a vii) b viii) d ix) c x) d

ACTIVITY

- Ask your parents about the date of various fixed assets purchased by them like T.V., Fridge, Motorcycle, Car etc., with its useful life and then calculate the amount of depreciation to be charged on each asset.

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15

PROVISIONS AND RESERVES

You know that businessmen prepare their accounts on the basis of going concern concept assuming that their business will continue for an indefinite period. Hence, in order to ascertain the net profit for each year, businessmen need to take into account not only the current contingencies but future contingencies also. In fact, provisions and reserves are such considerations which actually relate to the future needs for which a part of the current earnings has to be set aside.

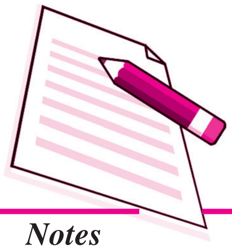
OBJECTIVES

After studying this lesson you will be able to

- understand the meaning and need of provision;
- understand the meaning and objectives of reserves;
- explain types of reserves and
- know the difference between provisions and reserves.

15.1 PROVISION : MEANING AND NEED

As you know in our daily routine life we make various arrangements for the future expected needs. For example, if your father wants to give you higher education such as Engineering, Doctorate, or any other professional course, he will need a lot of money. Now question arises how would your father be able to arrange such an amount? Yes, you are thinking right, he will start saving money from today and every year he will do the same. The events which are about to happen in the future are planned in the present with the help of available resources. In the same way these things are followed in a business also. When there are certain expected losses/ expenses, these are planned to



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be managed in advance from the current year's profits/ surplus. The amount which is kept separately to meet such expected losses/expenses is called a Provision.

If an amount is payable in the future and the amount is certain, it is a liability. For example, October month's rent, totalling ₹ 2,000. is payable on 31st October. The enterprise will debit Rent Account and Credit Rent Outstanding Account as it is a definite liability. However, if the amount in respect of a liability or expected loss is not certain, an estimated amount is set aside by debiting the Profit and Loss Account. The amount so set aside is known as a Provision. Thus, 'Provision' means an estimated amount to meet an uncertain loss or expense in future. Some of the examples of Provisions are: Provision for Doubtful Debts on Debtors, Provision for Discount on Debtors, Provision for Depreciation.

Needs of Provision

Provisions are provided for:

i) Depreciation, renewal or reduction in the value of assets.

ii) A known liability, the amount of which cannot be determined with substantial accuracy.

iii) A disputed claim.

iv) Specific loss on realization of an asset or on payment of taxes.

v) Redeeming the liability.

vi) Writing off bad-debts/doubtful debts.

vii) Contingent liabilities.

General rules in creation of Provisions:

i) It is created by debiting the profit and loss account.

ii) It is created to meet a known liability or a specific contingency, e.g. 'Provision for bad and doubtful debts' and 'provision for depreciation' etc.

iii) A provision is created irrespective of whether there is profit or loss in the business.

iv) It is not available for distribution as dividend among shareholders.

v) A provision is made for a definite amount and, therefore, a definite sum is set aside every year to meet the known contingency.

vi) Making of a provision is must to meet known liability or contingency.

vii) The provision is generally shown on the liability side of the balance sheet.

INTEXT QUESTIONS 15.1

Fill in the blanks with suitable words:

i. Provision means an estimated amount to meet an uncertain __________ or ________ in future.

ii. A provision may be provided for a __________ claim.

iii. A provision is created by debiting __________ account.

iv. A provision is not available for distributions as dividend among _________.

v. A provision in generally shown on _________ side of the balance sheet.

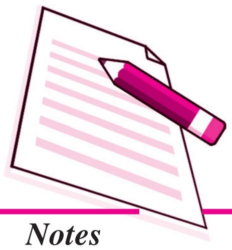
15.2 MEANING OF RESERVE

Our future is uncertain. There are a lot of contingencies, various needs and requirements in the future. Sometime we estimate for some unexpected losses/ expenses we may have to bear in the future. For this, we save some money from our current earning. If the unexpected event happens, we can use this saved money. Suppose your father earns ₹ 20,000 in a month and he does not set some money aside for any type of unexpected happening. In the mid of the month you get ill then how will your father manage for the various medical expenses for your treatment. Definitely, he will have to ask for money from friends, relatives etc. If they do not help your father, then think what will happen?

If your father had kept some money for these kinds of unexpected happenings, he would not have to face such types of troubles. Thus, an amount which is kept aside from our current income to meet the unexpected happening in the future is the reserve.

Future is uncertain, in the business there are a lot of happenings which may happen unexpectedly. For this arrangement of funds in a well planned manner is necessary. Some amount of total earned fund in a year is needed to set aside as a reserve.

Reserves are the amounts set aside out of profits. It is an appropriation of profits or accumulated profits to strengthen the financial position of the business. It is not a charge against profits. Reserves are not meant to cover any liability or depreciation in the value of assets. Examples are General Reserves, Reserves for Expansion, Reserve for Equalization of Dividends, Reserve for Increased Costs of Replacement, etc.



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15.3 TYPES OF RESERVES

Sometimes business, likely or certainly, has to anticipate some known or unknown future contingencies/emergencies. To meet this, business set aside a part of the profits and other surpluses which is called a reserve. Reserve is an appropriation of the profits and not a charge to it because it is not supposed to meet any known liability or diminution in the value of an asset. It is that part of profits that is kept aside to meet an unknown liability or for future emergency. It is created by debiting the P&L Appropriation A/c. It can be created only when there is profit in the business. It is usually shown on the liability side of the balance sheet. Reserves can be categorized into:

i. General Reserve	ii. Capital Reserve	iii. Secret Reserve
iv. Revenue Reserve	v. Specific Reserve	vi. Reserve Fund
vii. Sinking Fund		

i) **General reserve:** As the name suggests, the general reserve is not tied down to any specific purpose. It can be utilised to meet any future contingency or unknown liability. It is not legally mandatory to create a general reserve. It is created only when there is sufficient profit. It is shown on the debit side of P&L Appropriation A/c.

- It is created not for any specific purpose but for meeting future contingencies.
- It can be utilized for meeting any future loss.
- It is created only when there are sufficient profits.
- It is shown on the debit side of profit and loss appropriation account.
- Only distributable profits are reduced because of it.

This reserve is created by setting aside revenue profits. The object is to strengthen the general financial position of the business. It is not for a specific purpose. It is a free reserve. It acts as a safety cushion against all unforeseen contingencies in the future. It is immediately available for distribution as dividend profit.

General Reserves are retained profits. They are part of the surplus. They are the amount kept aside from profits. There can be no reserves if there are no profits. Reserves are undistributed profits. They are appropriations of profits. While provisions are a pre-profit matter, reserves are a post-profit matter. One cannot talk of creating reserves, without first finding out profits. It is a good business policy to create reserves. Reserve strengthen the financial position of the business. Reserves are created for different purposes. They may be for expansion of business; they may be for equalization of dividends or they may be for redemption of debentures

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or loans. Again, reserves may be created out of capital profits or out of revenue profits. The reserves created out of capital profits are called capital reserves, whereas, others are called revenue reserves.

ii) **Capital Reserve :** A capital reserve is generally created out of profits which are of capital nature only, such as capital gains, premium on issue of shares and debentures, profits prior to incorporation, profits on revaluation of assets and liabilities etc. It should not be distributed as dividend among the shareholders. It is used to strengthen the financial position of business, to write off capital losses or losses of abnormal nature.

Thus, the Capital Reserves

- Are appropriations from profits which cannot be distributed by way of cash dividends.
- Arise mainly from (i) equity transactions between the enterprise and its shareholders; (ii) from adjustments arising in accounting for business combinations; (iii) from differences arising on transactions of foreign currency operations; (iv) from surpluses arising from asset revaluation; (iv) any unrealized gain which has not been included in income.
- Examples of capital reserves includes: security premium, capital redemption reserves, capital reserves arising on merger and acquisition of a business, statutory reserves, asset revaluation reserve and exchange fluctuation reserves.

Capital reserves are created out of capital profits. Capital profits are not regular trading profits. They are profits on rare transactions. Capital reserves are generally not available for distribution as dividend. They are set aside to strengthen the financial position of the business or to meet capital losses. The following are the examples of capital profits :

a) Profit on sale of fixed' assets.

b) Profit prior to incorporation.

c) Profit on redemption of debentures.

d) Premium on issue of shares or debentures.

e) Profit on forfeiture of shares.

f) Profit on acquisition of business.

g) Profit which have not been earned in the regular course of business.

Capital reserves can be utilized in the following ways:

a) Issue of bonus shares.

b) Writing off goodwill.

c) Writing off preliminary expenses.

d) Writing off shares/debentures issue expenses.

e) Writing off losses prior to incorporation.

iii) **Secret Reserve :** Sometimes, a firm creates a reserve which is not shown in the balance sheet; it is known as secret reserve or hidden reserve or internal reserve. The existence of this reserve is not disclosed in the financial statements. It strengthens the financial position of the business, promotes confidence and stability. It is not created by joint stock companies except banking, insurance and financing companies.

iv) **Revenue Reserves :** Revenue Reserves are appropriation from revenue profits which can be distributed by way of cash dividends although some may be set aside for other purposes.

v) **Specific Reserve :** As the name suggests, the Specific Reserve is created for a specific purpose. It is utilised for only that purpose for which it has been created and not for purpose other than that. Whether a firm earns profit or suffers losses, it is obligatory for it to create specific reserve. It is shown on the debit side of P&L A/c. Examples of such reserves are- dividend equalization reserves, investment fluctuation reserves, plant replacement reserves and reserves for redemptions of debentures.

a) It is created for a specific purpose.

b) It is utilized for that specific purpose, for which it was created.

c) Whether profit or no profits, it must be created.

d) It is necessary to create in order to ascertain profit.

e) It is shown on the debit side of profit and loss account.

f) Net profits are reduced because of it.

This too is created by setting aside revenue profits. But it is for a specific purpose. This is not immediately available for distribution. For example, reserve created for redemption of debentures. During the period of liability, this reserve is not available for distribution. It becomes a general reserve on the redemption of debentures. Similarly, a reserve may be created for equalization of dividend.

vi) Reserve Fund : When a part of the profit set aside and used in the business, it is a reserve. But when a part of profits and other surplus is set aside and invested outside the business then it is known as reserve fund. In this case, the retained amount is invested in safe securities which are readily and easily realisable. Investments are not being carried for definite period. The purpose is to strengthen the financial position of the business house. Thus, the use of the term 'fund' indicates investment of reserve outside the business. Reserve fund Investments are not made for definite period. It is created always out of divisible profits. Interest received on investments representing reserve fund may not be re-invested.

Profit set aside and used in the business is a reserve. But profit set aside and invested outside the business is a reserve fund.

a) Investments are not for definite period.

b) It is created always out of divisible profits.

c) Interest received on investments representing reserve fund may not be re-invested.

vii) Sinking Fund : A sinking fund is established for the future redemption of the long-term debts or liabilities or for replacement of assets or to renew a lease. A sinking fund is a fund built up by annual contributions. The contributions are invested outside the business in readily realizable securities. Interest received on investments is reinvested in the same securities. Thus, a sinking fund may be (i) for replacement of fixed assets or (ii) for the redemption of debentures or repayment of loan. A sinking fund for the replacement of a fixed asset is a provision. But a sinking fund for redemption of debentures or repayment of loan is an appropriation of profits.

Reserves are appropriations of profit namely when profits have been ascertained after deducting all expenses which includes provision and others. Reserves are residual earnings after all expenses and taxation which belongs to the owners namely the shareholders.

a) Sinking fund Investments are for a definite period.

b) It is not always out of divisible profit e.g. sinking fund for replacement of asset is provision for depreciation, it must be created even if there are no profits.

c) In case of sinking fund, interest is always re-invested.

A sinking fund is a fund built up by annual contributions. The contributions are invested outside the business in readily realizable securities. Interest received on investments is reinvested in the same securities.

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A sinking fund may be (i) for replacement of fixed assets or (ii) for the redemption of debentures or repayment of loan. A sinking fund for the replacement of a fixed asset is a provision. But a sinking fund for redemption of debentures or repayment of loan is an appropriation of profits. A sinking fund represents amount invested outside the business.

General rules in creation of Reserves

i) It is created by debiting the profit and loss appropriation account.

ii) It is created to meet an unknown liability, or to strengthen the financial position of the company or for equalization of dividends etc.

iii) A reserve is created only when there is profit in the business.

iv) It can be distributed among shareholders as dividend.

v) The reserve debentures is created without taking into consideration the actual amount required except in the case of redemption of when a definite sum is set aside.

vi) Creation of reserve depends upon the financial policy of the business and discretion of its management.

vii) It is usually shown on the liability side of the balance sheet as it is not a specific reserve.

INTEXT QUESTIONS 15.2

Fill in the blanks with suitable words :

i. An amount kept aside from current income to meet unexpected happening in future is called ___________.

ii. It is not legally mandatory to create a ___________.

iii. ________ reserve is created out of __________ profit.

iv. Profit on sale of fixed assets is ___________ profit.

v. ________ reserve is not shown in the financial statement.

vi. Profit set aside and used in business is called a _____________.

vii. Profit set aside and invested outside the business is called ___________.

viii. Sinking Fund Investments are for a ___________ period.

15.4 DIFFERENCES BETWEEN PROVISION AND RESERVE

S. No.	Provisions	Reserves
1.	It is created by debiting the Profit & Loss A/c.	It is created by debiting the Profit & Loss Appropriation A/c.
2.	It is a charge against the profits without which true profit or loss of the business can't be ascertained.	It is an appropriation of profits and doesn't require to be created to ascertain true profit or loss.
3.	It has to be provided even if there is loss or no profit in the business. It is created irrespective of whether there is profit or loss in the business.	It can be created only when there is profit in the business.
4.	It can't be available to be distributed as dividend among the shareholders.	It can be distributed as dividend among the shareholders.
5.	It is a sum for known liability or for specific contingency e.g. provision for bad and doubtful debts, or provision for depreciation etc.	It is a sum to meet an unknown future liability or contingency or to strengthen the financial position of the business or for equalization of dividends etc.
6.	Making of a provision is a legal necessity for the management.	It is not legally obligatory to create a reserve. It depends upon the financial policy of the business and discretion of its management.
7.	Amount can't be utilized for purposes other than that for which they are created.	Amount can be utilized for any purpose because they represent undistributed profits.

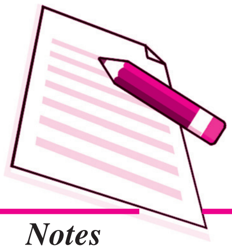
INTEXT QUESTIONS 15.3

I. State whether the following statements are True or False :

i. Provisions are the charges against profits for all apprehended losses.

ii. All reserves appear on the liability side of the balance sheet.

iii. Capital reserves are freely distributed as profits.



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iv. The purpose of reserve is generally to strength the financial position of a business enterprise.

v. A provision is made for a definite amount and therefore, a definite sum is set aside every year to meet the known contingency.

II. Multiple Choice Questions:

i. Out of the following which is not a provision:

a) Provision for bad debts.

b) Provision for discount on debtors.

c) Dividend Equalization Reserve.

d) Provision for Depreciation.

ii. Out of the following which is not a reserve:

a) Reserve for Expansion.

b) Dividend Equalization Reserve

c) Secret Reserve

d) Provision for bad debts.

iii. Out of the following name the reserve which is created not for any specific purpose but for meeting future contingencies:

a) General Reserve b) Capital Reserve

c) Specific Reserve d) Secret Reserve

iv. Out of the following name the reserve which can be utilised for issue of bonus shares:

a) General Reserve b) Capital Reserve

c) Secret Reserve d) Sinking Fund

v. Out of the following identify the item which is created by debiting the profit and loss appropriations Account:

a) Provision for bad debts

b) Provision for discount on debtors

c) Provision for Income tax

d) General Reserve

Notes

WHAT YOU HAVE LEARNT

- Provision is an estimated amount to meet an uncertain loss or expense of future e.g., Provision for Doubtful Debts on Debtors, Provision for Discount on Debtors, Provision for Depreciation, etc. Provisions are created out of profits and are generally shown on the liability side of the balance sheet. Making a provision is must to meet a known liability in future.

- An amount which is kept aside from current income to meet the unexpected happening in the future is called a reserve e.g. General Reserve, reserve for expansion, reserve for equalization of dividend etc. General Reserve is undistributed or retained profits. No reserve can be created if there is no profit. Reserves strengthen the financial positions of the business. Capital reserves are created out of capital profits eg. Capital gains, premiums on issue os shares and debentures, profits prior to incorporation etc. These reserves are not available for distribution of dividend. Secret reserve is not shown in the balance sheet. Revenue reserves are appropriations of profits which can be distributed as dividends. Specific reserve is created for a specific purpose e.g. dividend equalization reserve, investment reserve, investment fluctuation reserve etc. When a part of the profit is set aside and invested outside the business then it is known as a reserve fund. A Sinking fund is established for the future redemption of long term debts or liability or replacement of assets etc.

TERMINAL EXERCISE

1. What is meant by Reserve Fund?
2. What is meant by a provision?
3. Give the meaning of reserves.
4. State the purposes for which provision are created?
5. Why an organisation creates reserves? Explain briefly.
6. State the purposes for which capital reserves can be utilized.
7. Distinguish between provision and reserve (any four points).
8. Describe briefly the following:

i.	Secret Reserves	ii.	Revenue Reserves
iii.	Specific Reserves	iv.	Sinking Fund

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ANSWERS TO INTEXT QUESTIONS

15.1 i) Loss/expense ii) Disputed iii) Profit and Loss Account
iv) Shareholders v) Liability

15.2 i) Reserve ii) General Reserve iii) Capital, Capital iv) Capital
v) Secret vi) Reserve vii) Reserve Fund viii) Definite

15.3 I. i) True ii) True iii) False iv) True v) True
II. i) c ii) d iii) a iv) b v) d

ACTIVITY

- Your parents from their regular income make some savings for the known or unknown expenses/liability to meet out in future. Prepare a list of past three months savings with reasons and differentiate them in reserves or provisions keeping in view the principles of the same, so that you may be clear about the term reserve & provisions.

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16

FINANCIAL STATEMENTS : AN INTRODUCTION

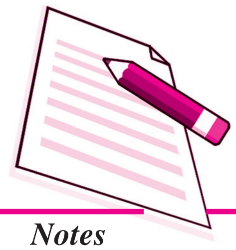
In the previous lessons you have learnt to record the business transactions in various books of accounts and their posting into ledger. You have also learnt about balancing the account and preparing the trial balance. One of the most important purposes of accounting is to ascertain financial results, i.e., profit or loss of the business operations of a business enterprise after a certain period and financial position on a particular date. For this certain financial statements are prepared which are termed as income statement (i.e. Trading and Profit & Loss Account) to know what the business has earned during a particular period and the Position Statement (i.e. Balance Sheet) to know the financial position of the business enterprise on a particular date.

In this lesson you will learn about the financial statements that are prepared by a profit organisations.

OBJECTIVES

After studying this lesson you will be able to :

- explain the meaning and the objectives of preparing financial statements;
- classify the financial statements into Trading and Profit & Loss Account and Balance Sheet;
- distinguish between capital expenditure and revenue expenditure, capital receipts and revenue receipts;
- explain the purpose of preparing Trading Account and Profit and Loss Account;
- draw the format of Trading Account and Profit and Loss Account and
- prepare the Balance Sheet.



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16.1 FINANCIAL STATEMENTS : MEANING AND OBJECTIVES

When a student has studied for a year, he/she wants to know how much he/she has learnt during that period. Similarly, every business enterprise wants to know the result of its activities of a particular period which is generally one year and what is its financial position on a particular date which is at the end of this period. For this, it prepares various statements which are called the financial statements.

> Financial statements are the statements that are prepared at the end of the accounting period, which is generally one year. These include Income Statement i.e. Trading and Profit & Loss Account and Position statement i.e. Balance Sheet.

Objectives of preparing Financial Statements

Financial statements are prepared to ascertain the profits earned or losses incurred by a business concern during a specified period and also to ascertain its financial position at the end of that specified period.

Financial statements are generally of two types (a) Income Statement which comprises of Trading Account and Profit & Loss Account, and (b) Position Statement i.e., the Balance Sheet.

Following are the objectives of preparing financial statements: -

1. **Ascertaining the results of business operations :** Every businessman wants to know the results of the business operations of his enterprise during a particular period in terms of profits earned or losses incurred. Income statement serves this purpose.

2. **Ascertaining the financial position :** Financial statements show the financial position of the business concern on a particular date which is generally the last date of the accounting period. Position statement i.e. Balance Sheet is prepared for this purpose.

3. **Source of information :** Financial statements constitute an important source of information regarding finance of a business unit which helps the finance manager to plan the financial activities of the business and making proper utilisation of the funds.

4. **Helps in managerial decision making :** The Manager can make comparative study of the profitability of the concern by comparing the results of the current year with the results of the previous years and make his/her managerial decisions accordingly.

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5. **An index of solvency of the concern :** Financial statements also show the short term as well as long term solvency of the concern. This helps the business enterprise in borrowing money from bank and other financial institutions and/or buying goods on credit.

Importance of Financial Statements

i. **Pertaining to Finance :** The term "financial statement" doesn't make sense at first. Numbers are for counting while statements need words, so how could these two mix together? But when seen as "money statements," then suddenly it's a crucially important matter.

ii. **Facilitate in Decision Making :** Not only is it important for you, but for the management and stockholders as well. It's important for the management because financial statements speak of the company's success and competence, whereas stockholders refer to financial statements to know whether or not to invest in a company. In other words, financial statements tell whether the company made or lost money.

iii. **Showing the Operational Performance :** Financial statement hold the secrets of a company. Aside from stating whether the company earns or loses money, they also provide clues on where the mangement might find more resources to boost its revenue. In addition, financial statements reveal a company's past performance and potential.

Capital Expenditure and Revenue Expenditure, Capital Receipts and Revenue Receipts

The preparation of Trading Account and Profit and Loss Account requires the knowledge of revenue expenditure, revenue receipts and capital expenditure and capital receipts. The knowledge shall facilitate the classification of revenue items and put them in the Trading account and Profit and Loss Account on one hand and prepare Balance Sheet based on capital items (expenditure as well as receipts) on the other hand.

Capital Expenditure refers to the expenditure incurred for acquiring fixed assets or assets which increase the earning capacity of the business. The benefits of capital expenditure to the firm extend to number of years. Examples of capital expenditure are expenditure incurred for acquiring a fixed asset such as building, plant and machinery etc.

Revenue expenditure, on the other hand, is an expenditure incurred in the course of normal business transactions of a concern and its benefits are availed of during the same accounting year. Salaries, carriage etc. are examples of revenue expenditure.

There is another category of expenditure called **deferred revenue expenditure**. These are the expenses incurred during one accounting year but benefits from the same are available wholly or in part in future periods also. These expenditures are otherwise of a revenue nature. Example of deferred revenue expenditure are heavy expenditure on advertisement say for introducing a new product in the market, expenditure incurred on research and development, etc.

Difference between Capital Expenditure and Revenue Expenditure

Basis of Difference	*Capital Expenditure*	*Revenue Expenditure*
1. Purpose	It is incurred for acquiring fixed assets.	It is incurred for the maintenance of fixed assets.
2. Earning capacity	It increases the earning capacity of the business.	It helps in maintaining the earning capacity of the business intact.
3. Periodicity of benefit	Its benefits are spread over a number of years.	Its benefits accrue only in one accounting year.
4. Placement in financial statements	It is an item of Balance Sheet and is shown as an item of asset.	It is an item of Trading and Profit and Loss Account and is shown on the debit side of either of the two.
5. Occurrence of expenditure	It is non-recurring in nature.	It is usually a recurring expenditure.

Capital and Revenue Receipts

Capital receipts are receipts which do not arise out of normal course of business. Examples of such receipts are sale of fixed assets, and raising of loans etc. Such receipts are not treated as income of the enterprise.

Revenue receipts are receipts which arise during the normal course of business, Sale of goods, rent from tenants, dividend received, etc. are some of the examples of revenue receipts. They are the items of incomes of the business entity.

Distinction between Capital Receipts and Revenue Receipts

Basis of Difference	*Capital Receipt*	*Revenue Receipt*
Source	Receipts that do not arise during the normal course of business.	Receipts that arise during the normal course of business.
Nature	These are of capital nature and hence are not treated as items of income of the business.	These are of revenue nature and hence are treated as items of income of the business.
Occurrence	These are of non-recurring in nature.	These are recurring in nature.

INTEXT QUESTIONS 16.1

I. Classify the following items of expenditure into capital expenditure revenue expenditure and deferred revenue expenditure

(i) Amount spent on purchase of machine.

(ii) Expenditure incurred on repairs of building.

(iii) Heavy expenditure on advertisement to introduce a new product in the market.

(iv) Purchase of motor vehicle for business use.

II. One important objective of financial statements is to ascertain the results of business operations. List the other objectives of the financial statements:

(a) ....

(b) ....

(c) ....

(d) ....

16.2 TRADING ACCOUNT

Income statement consists of Trading and Profit and Loss Account. Let us, first study the Trading Account. A business firm either purchases goods from others and sells them or manufactures and sells them to earn profit. These are known as trading activities. A statement is prepared to know the results in terms of profit or loss of these activities. This statement is called Trading Account.

Notes

Trading Account is prepared to ascertain the results of the trading activities of the business enterprise. It shows whether the selling of goods purchased or manufactured has earned profit or incurred loss for the business unit. Cost of goods sold is subtracted from the net sales of the business of that accounting year. In case the total sales value exceeds the cost of goods sold, the difference is called Gross Profit. On the other hand, if the cost of goods sold exceeds the total net sales, the difference is Gross Loss. All accounts related to cost of goods sold such as opening stock, net purchases i.e. purchase less returns outward, direct expenses such as wages, carriage inward etc. and closing stock with net sales (i.e. Sales minus Sales returns) are posted to the Trading Account. Then this account is balanced. Credit balance shows the gross profit and debit balance shows the gross loss.

It is necessary to understand the meaning of cost of goods sold before preparing Trading Account.

Cost of goods sold and gross profit

A business enterprise either purchases goods or manufactures goods to sell in the market. Cost of goods sold is computed to know the profit earned (Gross Profit) or loss incurred (Gross Loss) from the trading activities of a business unit for a particular period.

Cost of goods sold = the amount of goods purchased + expenses incurred in bringing the goods to the place of sale or expenses incurred on manufacturing the goods (called direct expenses).

In case there is a stock of goods to be sold in the beginning of the year or at the end of the year, the cost of goods is calculated as follows :

Cost of goods sold = Opening stock + Net purchases + All direct expenses – Closing stock

Gross Profit = Net sales – Cost of goods sold

Illustration 1

Calculate the cost of goods sold from the following information :

	₹
Opening stock	10000
Closing stock	8000
Purchases	80000
Carriage on purchases	2000
Wages	6600

Solution :

Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses (Carriage on Purchases + Wages) – Closing Stock

= ₹ [10,000 + 80,000 + 86,00

(i.e. 2,000 + 6,600) – 8,000]

= ₹ 90600

Illustration 2

Calculate cost of goods sold and gross profit from the following information.

Sales	₹ 62500
Sales Returns	₹ 500
Opening Stock	₹ 6400
Purchases	₹ 32000
Direct Expenses	₹ 4200
Closing Stock	₹ 7200

Solution :

			₹
Net sales			
(Sales-Sales Returns i.e. 62500 – 500)			62000
Less :	Cost of goods sold		
	Opening Stock	6400	
	Add Purchases	32000	
	Add Direct Expenses	4200	
Less :	Closing Stock	(7200)	35400
	Gross Profit		26600

Or Gross profit = Net sales – cost of goods sold

= 62000 – 35400 = 26600

Illustration 3

From the following information for the year ending 31st March, 2014 furnished by Mr. Vikram, a trader, calculate cost of goods sold and also calculate Gross Profit/Gross Loss of business.

	₹
Sales	1,20,000
Purchases	80,000
Octroi	1,600
Carriage on purchases	4,500
Purchase Returns	2,400
Opening Stock	27,600
Closing Stock	32,400

Solution :

	₹
Cost of goods sold :	
Opening stock	27,600
Add Net Purchases	
(₹ 80,000 – ₹ 2,400)	77,600
Add carriage on Purchases	4,500
Add Octroi	1,600
Cost of goods available for sale	1,11,300
Less closing stock	32,400
Cost of goods sold	78,900

Gross Profit :	₹
Sales	1,20,000
Less : Cost of goods Sold	78,900
Gross Profit	41,100

Need of Trading Account

Trading Account serves the following purposes :

1. **Knowledge of Gross Profit :** Trading Account gives information about Gross Profit. It is the profit earned by a business enterprise from its trading activities. The percentage of gross profit on sales reflects the degree of success of business.

2. **Knowledge of All Direct Expenses :** All direct expenses are debited to trading Account. Direct expenses are the expenses that can be directly attributed to purchase or manufacturing of goods for sale. Percentage of Direct expenses on sales of current year when compared with the same of previous years, helps the manager to exercise control over direct expenses.

3. **Precaution against Future Losses :** Trading Account, if shows gross loss, reasons for this loss can be found out and necessary corrective steps can be taken.

FORMAT OF TRADING ACCOUNT

Trading Account of ....

for the year ending ....

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Opening Stock		Sales	
Purchases		Less: Sales Returns	
Less Purchase Returns		Closing stock	
Direct Expenses :		Gross loss transferred to	
Carriage Inward		Profit & Loss Account	
Freight			
Wages			
Fuel & Power			
Excise Duty			
Factory Rent			
Heating & Lighting			
Factory Rent & Insurance			
Work Managers Salary			
Gross Profit transferred to Profit & Loss Account			

Important Items of Trading Account

Important items of Trading account are :

Notes

1. **Stock :** Stock refers to the goods lying unsold on a particular date. It can be of two types : **(a) Opening stock and (b) Closing stock**

   (a) ***Opening Stock :*** Opening stock refers to the value of goods lying unsold at the beginning of the accounting year. It is shown on the debit side of the Trading Account. In the first year of business there is no opening stock.

   (b) ***Closing Stock :*** It is the value of goods lying unsold at the end of the accounting year. It is valued at the cost price or market price whichever is less. It is shown on the credit side of the Trading Account.

2. **Purchases :** Purchases mean total items purchased for resale during the year. It can be both in cash and on credit. Purchases are shown on the debit side of the Trading Account. These are always shown as net purchases i.e. amount of purchases returned (Purchase returns or return outwards) is deducted from the total amount of purchases made. Goods received on consignment basis are never treated as purchases. Similarly, goods received on 'sale or return' basis are never treated as purchases.

3. **Sales :** Sales refer to the total revenue from sale of goods of the business enterprise for which the Trading Account is being prepared. It includes both cash sales and credit sales. These are recorded on the credit side of the Trading Account. Sales are shown at their net value i.e. sales return or returns inward is deducted from the total sales. Cash sales plus credit sales minus sales returns constitute net sales. Goods sent on 'sale or approval' are not part of sales until approval is received.

4. **Direct Expenses :** Direct expenses are the expenses that can be attributed directly to the purchase of goods or goods manufactured. These are shown on the debit side of the Trading Account. These are shown at the amount as shown in the Trial Balance. For example, wages are recorded on the debit side of Trading Account at the amount shown in the Trial Balance.

   Important Items of Direct Expenses

   1. Wages i.e. wages relate to production. If amount under this head includes wages paid for construction of building or manufacturing of furniture for office it will be subtracted from the amount of wages.

   2. Carriage, Cartage and Freight i.e. amount paid for carriage of goods purchased for sale or raw material purchased for manufacturing.

   3. Other such direct expenses are customs and import duty, packing materials, gas, electricity water, fuel, oil, gas greese, heating and lighting, factory rent and insurance and many more such items.

5. **Gross Profit/Gross Loss :** It is the excess of net sales revenue over cost of goods sold. Gross Profit is equal to net sales minus cost of goods sold. If total of the credit side exceeds the total of debit side, the excess amount is termed as 'gross profit' and is shown on the debit side of Trading Account. On the other hand if debit side is more than the credit side, the difference in amount is called gross loss and is shown on the credit side of the Trading Account.

> Gross Profit = Net Sales – Cost of Goods Sold
>
> Gross Loss = Cost of Goods Sold – Net Sales

INTEXT QUESTIONS 16.1

I. Fill in the blanks with suitable word/words :

1. Financial statements are generally of .... Types.
2. Income statement comprises of .... A/c and .... A/c.
3. Trading Account is prepared to ascertain the .... profit of the business.
4. The percentage of gross profit on sales reflects the degree of .... of business.

II. Show the result in the following cases

(a) Sales – sales return = ...

(b) Purchases – purchases return = ...

(c) Total of the credit column of trading account – total of the debit column of trading account = ...

(d) Cost of goods sold – total sales = ...

(e) Total of the debt column of trading account - Total of the credit column of trading account = ...

16.3 TRANSFER ENTRIES

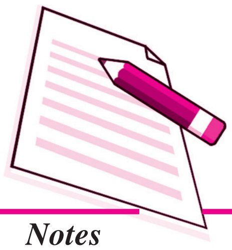
Before preparing Trading Account, closing or transfer journal entries are made in the journal proper of the business enterprise. These journal entries are:

(a) For transferring debit balances

Trading A/c   Dr.

    To Opening stock

    To Purchases



Notes

To Direct expenses

To Sales returns

(Transfer of balances of opening Stock, Purchases, direct expenses & Sales Returns)

(b) For transferring credit balances

Sales A/c Dr.

Closing stock A/c Dr.

Purchase Returns A/c Dr.

To Trading A/c

(Transfer of credit balances of Sales, Closing Stock, Purchase return)

(c) For transferring gross profit

Trading A/c Dr

To Profit & Loss A/c

(Transferring of gross profit)

(d) For transferring gross loss

Profit & Loss A/c Dr.

To Trading A/c

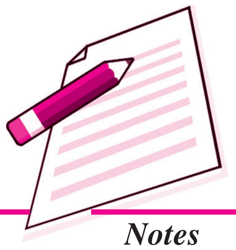
(Transferring of gross loss)

Illustration 4

The ledger balances extracted at the close of a trading year on 31st March, 2014 are given as follows

Name of the Account	*Amount (₹)*
Opening stock	12,000
Purchases	52,000
Sales	74,000
Purchase Returns	2,000
Carriage Inward	800
Wages	4,200
Closing stock	13,500

Pass necessary journal entries in the journal proper.



Notes

Solution :

Journal

Date 2014	*Particulars*		*LF*	*Dr Amount ₹*	*Cr Amount ₹*
March 31	Trading A/c	Dr		69,000	
	To Opening stock A/c				12,000
	To Purchases A/c				52,000
	To Wages A/c				4,200
	To Carriage Inward A/c				800
	(Transfer of debit balances to trading Account)				
March 31	Sales A/c	Dr		74,000	
	Purchase Returns A/c	Dr		2,000	
	Closing stock A/c	Dr		13,500	
	To Trading A/c				89,500
	(Transfer of credit items to trading account)				
March 31	Trading A/c	Dr		20,500	
	To Profit & Loss A/c				20,500
	(Transfer of gross profit to Profit & Loss Account)				

Illustration 5

Following balances have been extracted from the ledger of Rohit & Sons at the close of the year 2014.

	₹
Stock (1.1.2014)	21,000
Purchases	1,40,000
Sales	2,24,000
Purchases Returns	8,000

Sales Returns	12,000
Wages	15,000
Factory Power	12,000
Stock (31.12.2014)	26,500

Make closing journal entries in the journal proper.

Solution :

Journal

Date 2014	*Particulars*	*LF*	*Dr Amount*	*Cr Amount*
Dec. 31	Trading A/c Dr		2,00,000	
	To Opening stock A/c			21,000
	To Purchases A/c			1,40,000
	To Sales Returns A/c			12,000
	To wages A/c			15,000
	To Factory power A/c			12,000
	(Closing entry of debit items transferred to Trading A/c)			
	Sales A/c Dr		2,24,000	
	Closing stock A/c Dr		26,500	
	Purchase Returns A/c Dr		8,000	
	To Trading A/c			2,58,500
	(Transfer of credit balances to Trading A/c)			
	Trading A/c Dr		58,500	
	To Profit & Loss A/c			5,8500
	(Transfer of Gross Profit)			

INTEXT QUESTIONS 16.3

Write the "debit" if the items given below are to be placed in debit side of the Trading A/c and "Credit" if they are placed in the credit side of the Trading Account.

(i) Closing stock

(ii) Carriage inward

(iii) Sales

(iv) Custom duty

16.4 PROFIT & LOSS ACCOUNT

As stated earlier, income statement consists of two accounts : Trading Account and Profit & Loss Account. You have seen that Trading account is prepared to ascertain the gross profit or gross loss of the trading activities of the business. But these are not the final results of business operations of an enterprise. Apart from direct expenses, there are indirect expenses also. These may be conveniently divided into office and administrative expenses, selling and distribution expenses, financial expenses, depreciation and maintenance charges etc.

Similarly, there can be income from sources other than sales revenue. These may be interest on investments, discount received from creditors, commission received, etc. Another account is prepared in which all indirect expenses and revenues from sources other than sales are presented. This account when balanced shows net profit (or net loss). This account is termed as Profit and Loss Account. The profit shown by this account is called 'net profit' and if it shows loss it is known as 'net loss'.

FORMAT OF PROFIT AND LOSS ACCOUNT

Profit and Loss A/c of M/s ....…..

for the year ended ....

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Gross loss b/d; if any	—	Gross Profit b/d	—
Salaries	—	Discount Received	—
Rent, Rates & taxes	—	Commission Received	—
Insurance Premium	—	Dividend Received	—

Advertising	—	Interest on Investment	—
Commission paid	—	Rent Received	—
Discount Allowed	—	Net Loss transferred	
Repairs & Renewals	—	to capital account; if any	—
Bad Debts	—		
Establishment charges	—		
Travelling Expenses	—		
Bank Charges	—		
Sales Tax/Value added Tax	—		
Depreciation on fixed assets	—		
Net Profit transferred to Capital Account	—		

Some important items of Profit and Loss Account

As stated earlier indirect expense are shown on the debit side of Profit and Loss A/c. These can be classified under the following heads :

Debit Items

1. **Selling and Distribution Expenses :** To materialise sales, the expenses incurred are called selling and distribution expenses. Examples are :

   Carriage on sales/carriage outwards, advertisement, selling expenses, travelling expenses and salesman commission, depreciation of delivery van, salary of driver of the delivery van, etc.

2. **Office and Administration Expenses :** These are the expenses incurred on establishment and maintenance of office. Some of the expenses that may be under this head are: rent, rates and taxes, postage, printing and stationery, insurance, legal charges, audit fees, office salaries, etc.

3. **Financial Expenses :** Finances are to be arranged for carrying on business. Expenses that are incurred in this connection are called financial expenses. Some of the financial expenses are: interest on loan, interest on capital, discount on bills, etc.

4. **Depreciation and Maintenance Charges :** The total value of a fixed asset like machinery, building, furniture, etc. is not charged to profit and loss account in the year in which it is purchased. Such assets help running business for a number of

years to come. Therefore, only a part of the value of such assets is treated as an expense and is charged to Profit and Loss A/c as depreciation. Depreciation means decline in the value of fixed asset due to wear and tear, lapse of time, obsolescence, etc. Expense incurred on repairs and renewals and maintenance of assets are expenses other than depreciation under this category.

5. **Other Expenses :** These are the expenses which are not included under the above mentioned heads of expenses for example, losses and expenses due to fire, theft etc.

Credit Items

On the credit side of Profit and Loss Account, items of revenue and incomes are written. The first item on this side of Profit and Loss Account is the gross profit transferred from trading account. Other items of the credit side are : Interest on investment, interest on fixed deposits etc. rent received, commission received, discount received, dividend on shares received etc.

Need of preparing Profit and Loss Account

Need of preparing profit and loss account by a business concern may be stated as follows :

(i) To know the net profit or net loss of a business for an accounting year.

(ii) Net profit of one year can be compared with net profits of previous year or years. It helps in ascertaining whether the business is being conducted efficiently or not.

(iii) Different expenses which are taken to Profit & Loss A/c in one year can be compared with the amounts incurred in previous year or years. This helps in ascertaining the need of applying control over such expenses.

INTEXT QUESTIONS 16.4

I. Following are the items of expenditure and income to be taken to Profit and Loss Account. Write 'E' for expenses and 'I' for income against each item.

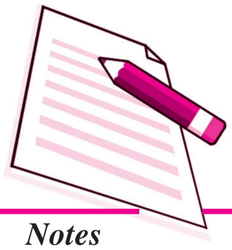
(i) Interest on Fixed Deposit

(ii) Advertisement

(iii) Insurance Premium

(iv) Discount allowed by creditors

(v) Carriage on sales



Notes

II. State whether the following statements are 'true or false'. Write true for true statements and 'false' for false statements.

(i) Profit and Loss Account is prepared to ascertain the Gross Profit of a business unit.

(ii) Items of income are written on the credit side of Profit and Loss Account.

(iii) Net Profit calculated by preparing Profit and Loss Account is transferred to Trading Account.

(iv) Profit and Loss Account is prepared for an accounting year.

16.5 TRANSFERRING ENTRIES OF PROFIT AND LOSS ACCOUNT

Before preparing Profit and Loss Account as per the format given in the previous section, closing entries are made in the journal proper of the enterprise. Following journal entries are made :

(i) For transferring the indirect expense accounts :

Profit & Loss A/c	Dr.
To Salaries A/c	
To Insurance Premium A/c	
To Bad Debts A/c	
To Discount Allowed A/c	
(Transfer of indirect expenses)	

(ii) For transfer of items of incomes and gain

Interest on investment A/c	Dr.
Rent Received A/c	Dr.
Discount Received A/c	Dr
To Profit & Loss A/c	
(Transfer of items of income)	

(iii) For transferring Net Profit :

Profit & Loss A/c	Dr.
To Capital A/c	
(Transferring of Net Profit to Capital A/c)	

(iv) For transferring Net Loss

Capital A/c Dr.

To Profit & Loss A/c

(Transfer of Net Loss to Capital Account)

Illustration 6

The following balances were extracted from the books of Maya Gupta & Sons at the end of March 31, 2014. Make necessary closing entries as on that date:

Items	*Dr. Balance (₹)*	*Cr. Balance (₹)*
Gross Profit	65,000	
Salaries	11,500	
Audit fees	400	
Insurance Premium	800	
Interest received		1,600
Discount (Cr)		460
Advertisement	1,200	
Bad Debts	150	
Discount Allowed	340	
Depreciation	460	
Rent from tenants	—	1,800

Notes

Solution :

Journal Entries

(i)	Trading A/c	Dr.	65,000	
	To P&L A/c			65,000
	(Gross profit transfered to P&L A/c)			
(ii)	Profit & Loss A/c	Dr.	14850	
	To Salaries A/c			11500
	To Audit Fees A/c			400

Notes

	To Insurance Premium A/c			800
	To Advertisement A/c			1200
	To Bad Debts A/c			150
	To Discount Allowed A/c			340
	To Depreciation A/c			460
	(Transfer of items of expenses to profit & Loss A/c)			
(iii)	Interest A/c	Dr.	1600	
	Discount Received A/c	Dr.	460	
	Rent A/c	Dr.	1800	
	To Profit & Loss A/c			3860
	(Transfer of items of income to Profit & Loss A/c)			
(iv)	Profit & Loss A/c	Dr.	54010	
	To Capital A/c			54010
	(Transfer of Net Profit to Capital Account)			

Illustration 7

The following ledger balances were extracted from the books of Rabina & Brothers at the end of accounting year 31st March, 2014. Make journal entries to transfer these balances to prepare Profit & Loss A/c for the year ending 31st March, 2014.

	₹
Gross Profit	65800
Salaries	8400
Rent paid	2400
Discount allowed	500
Interest on investments	3100
Advertisement	1800
Trading expenses	1600
Bad Debts	500
Depreciation	600
Insurance Premium	800
Commission received	2700

Notes

Solution :

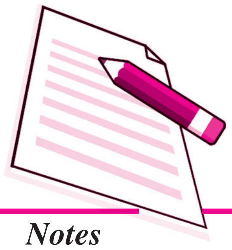
Trading A/c	Dr.	65,800	
To P & L A/c			65,800
(Gross profit transferring to P&L A/c)			

Journal

Date 2014	*Particulars*		*LF*	*Dr Amount*	*Cr Amount*
March 31	Profit & Loss A/c	Dr		16600	
	To Salaries A/c				8400
	To Rent A/c				2400
	To Discount allowed A/c				500
	To Advertisement A/c				1800
	To Trading expenses A/c				1600
	To Bad Debts A/c				500
	To Depreciation A/c				600
	To Insurance Premium A/c				800
	(Transfer of indirect expenses to profit & Loss A/c)				
March 31	Commision A/c	Dr		2700	
	Interest A/c	Dr		3100	
	To Profit & Loss A/c				5800
	(Transfer of incomes other than sales to Profit & Loss A/c)				
March 31	Profit & Loss A/c	Dr		55000	
	To Capital A/c				55000
	(Transfer of net profit to capital A/c)				

Operating Profit

Operating profit is the excess of gross profit over operating expenses. Gross Profit is the excess of net sales revenue over cost of goods sold. Operating expenses includes office and administration expenses, selling and distribution expenses, cash discount allowed, interest on bills payable and other short term debt, bad debts and so on. Net sales means cash sales + credit sales - sales returns.



Notes

Operating Profit = Net Sales - Operating Cost

= Net Sales - (Cost of goods sold + administration and office exp. + Selling and Distribution expenses)

Operating Profit = Net Profit + Non-operating exp. - Non-Operating Income

Illustration 8

Compute Operating profit from the following particular.

	₹		₹
Gross Profit	44,000	Interest on loan	2200
Carriage outward	480	Interest on investment	280
Advertising	1200	Printing and Stationery	360
Salaries	17,800	Loss on Sale of furniture	3,500
Rent & Taxes	6,200	General expenses	140
Lighting	1,500	Donation	510
Insurance charge	240	Rent Received	600
Bad Debts	150	Loss by fire	2,000
Audit fees	200	Gain on sale of machine	5,000

Solution

Computation of Operating Profit

			₹	₹
Gross Profit				44,000
Less :	Selling and Distribution expenses :			
	Carriage outward	480		
	Advertising	1,200		
	Bad Debts	150	1,830	
Less :	Office and Administrative Expenses			
	Salaries	17,800		
	Rent & Taxes	6,200		
	Lighting	1,500		
	Insurance	240		
	Audit fees	200		
	Printing & Stationery	360		
	General expense	140	26,440	(28,270)
Operating Profit				15,730

Position Statement/Balance Sheet

Position Statement or Balance Sheet is another financial statement that a business enterprise prepares. Balance Sheet is a statement prepared on a particular date, generally at the end of accounting year to ascertain the financial position of the business entity. It consists of assets on the one hand and liabilities on the other.

> In the words of Francis R Steal, “Balance Sheet is a screen picture of the financial position of a going business at a certain moment.” In the words of Freeman, “A Balance Sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain date.”

Financial position of a business is the list of assets owned by the business and the claims of various parties against these assets. The statement prepared to show the financial position is termed as Balance Sheet.

In the next lesson we shall discuss Balance Sheet in detail.

INTEXT QUESTIONS 16.5

I. Write ‘debit’ if Profit and Loss Account is to be debited and ‘credit’ if profit and loss account is to be credited of the following items :

(a) Legal charges (b) Net Loss (c) Rent Received

(d) Discount Allowed (e) Salaries

II. (a) Name the financial statement which is prepared in addition to income statement.

(b) Why it is prepared?

(c) When it is prepared?

(d) Name its two elements.

III. (a) Operating Profit = Net Sales - ________________

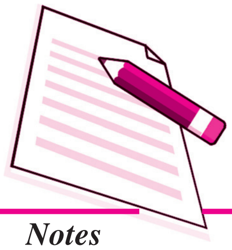
(b) Operating Profit = Net Profit + Non-Operating Expenses - ___________

(c) If Net Sales = ₹ 2,00,000 and Operating cost = ₹ 1,50,000 than calculate Operating profit.

WHAT YOU HAVE LEARNT

- Financial statements are of two types :

  (a) Income Statement i.e. Trading Account and Profit and Loss Account.



Notes

(b) Position Statement i.e. Balance Sheet.

- Trading Account is prepared to ascertain the results of the trading activities of the business.
- Trading Account may show profit (i.e. the excess of sales to cost of goods sold or excess of credit side over debit side), which is termed as Gross Profit.

  Trading Account may show loss (i.e. Cost of goods sold exceeds sales or total of debit side exceeds total of credit side). This is called Gross Loss.
- Profit and Loss Account is prepared to find out Net Profit/Net Loss.

  Net Profit = Gross Profit + other incomes – Indirect expenses.

  It may also show a net loss.

  All indirect expenses are shown on the debit side of Profit & Loss Account.

  All incomes and gains are shown on the credit side of Profit & Loss Account.
- Balance Sheet is prepared to ascertain the financial position of a firm on a particular date.

TERMINAL EXERCISE

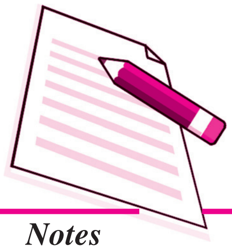
1. State the meaning of financial statements.
2. Explain in brief the various objectives of finanacial statements.
3. Explain in brief the following terms with two examples of each :
   (a) Revenue expenditure.
   (b) Revenue Receipts
   (c) Capital expenditure
   (d) Capital Receipts
4. Distinguish between capital expenditure and Revenue expenditure on the basis of:
   (a) Earning capacity
   (b) Placement in financial statements
   (c) Occurrence of expenditure
5. Distinguish between capital receipts and revenue receipts.
6. How is cost of goods sold calculated?

7. What is Trading Account? Why is it prepared?
8. How is Gross Profit calculated?
9. What is meant by Profit and Loss Account? Why is it prepared?
10. When does Profit and Loss Account show Net Profit?
11. What are direct expenses? Give two examples of such expenses.
12. State the meaning of Balance Sheet.
13. From the following balances of Sabana calculate Gross Profit or Gross Loss by subtracting cost of goods sold from sales for the year ended 31st December, 2014

	₹
Stock (1.1.2014)	26500
Purchases	64600
Sales	86800
Purchases Returns	2600
Sales Returns	1800
Freight inward	750
Wages	1850
Closing Stock	31100

14. From the following balances extracted from the books of Seth Brothers. Pass journal entries to prepare a Trading Account and Profit and Loss Account for the year ended 31st March, 2014.

	₹		₹
Stock (1.4.2013)	20000	Electric Power	5000
Purchases	95000	Wages	14000
Return Inwards	2000	Selling Commission	5500
Carriage Inwards	1850	Repair & Renewals	2000
Carriage Outwards	1200	General Expenses	8000
Custom duty	3000	Insurance	2200
Return outwards	5000	Stock (31.3.2014)	45000
Sales	165000		
Discount Received	1500		



15. The balances from the books of Parimal Ghosh are given below. Pass journal entries to prepare Trading and Profit & Loss Account for the year ended 31st March, 2014

	₹		₹
Stock as on 1.4.2013	9480	Purchase Returns	1800
Purchases	50800	Advertising	1500
Wages	1200	Commission (Cr.)	3200
Salaries	3400	Rent from tenant	2800
Octroi	1320	Sales	72000
Rent & Taxes	850	Stock (31.3.2014)	10700
Bad Debts	250		
Discount (Dr.)	360		
Interest on capital	760		

16. From the following information calculate cost of goods sold for the year ending 31st March, 2014

	₹		₹
Opening Stock	14800	Factory expenses	7200
Purchases	65700	Closing stock	28400
Returns outward	1700		
Wages	12500		
Carriage Inward	2400		
Custom Duty	3200		
Rent paid	4500		
Establishment expenses	650		

17. From the following balances extracted from the books of Jai Bhagwan & Sons as on 31st March, 2014. Pass journal entries to prepare Trading A/c and Profits & Loss A/c

	₹		₹
Opening Stock	16000	Rent	3600
Purchases	76000	Office expenses	1600
Machinery	28000	Carriage Inward	1200

Debtors	21600	Sales Returns	5400
Drawings	7200	**Credit Balance**	
Wages	1500	Capital	70000
Bank	12000	Creditors	14000
Depreciaiton	2800	Sales	108000
Closing stock	24000	Purchase Returns	2600

ANSWERS TO INTEXT QUESTIONS

16.1 I. (i) Capital (ii) Revenue

(iii) Deferred Revenue (iv) Capital

II. (a) Ascertaining the financial position

(b) Source of information

(c) Helps in managerial decision making

(d) An index of the solvency of the concern.

16.2 I. 1. Two 2. Trading and Profit & Loss

3. Gross Profit 4. Success

II. (a) Net sales (b) Net purchases (c) Gross profit

(d) Gross Loss (e) Gross Loss

16.3 (i) Credit (ii) Debit (iii) Credit (iv) Debit

16.4 I. (i) I (ii) E (iii) E (iv) I (v) E

II. (i) F (ii) T (iii) F (iv) T

16.5 I. (a) debit (b) debit (c) Credit (d) debit (e) debit

II. (a) Balance sheet

(b) to show the financial position of the concern

(c) At the end of an accounting year

(d) assets; liabilities

III. (a) Operating Cost (b) Non-operating income

(c) ₹ 50,000

Notes

ANSWERS TO TERMINAL EXERCISE

13. Gross Profit : ₹ 25000
14. Gross Profit : ₹ 74150 Net Profit : ₹ 56750
15. Gross Profit : ₹ 21700 Net Profit : ₹ 20580
16. Cost of goods sold : ₹ 75700
17. Gross Profit : ₹ 21000 Net Profit : ₹ 13000

ACTIVITY

Procure trial balance of at least four business concerns and classify the items into :

(a) Revenue expenditure (b) Revenue receipts

(c) Capital expenditure (d) Capital Receipts

Name of organisation	*Item of expenditure*	*Revenue expenditure*	*Revenue receipts*	*Capital expenditure*	*Capital Receipts*

320en17

17

FINANCIAL STATEMENTS : I

You have learnt the meaning of the financial statements and the need to prepare these statements for the business organisations. You have also learnt the format of these statements and the important items that are recorded in these statements. You would now like to learn how to prepare these statements. You know Trial Balance is the basis of preparation of these statements. Every business organisation prepares two financial statements i.e. Trading and Profit and Loss A/c and the Balance sheet.

In this lesson you will learn the prepration of these statements.

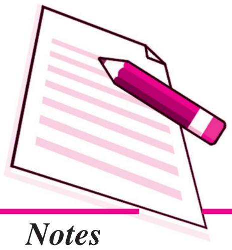
OBJECTIVES

After studying this lesson you will be able to :

- prepare Trading Account and Profit and Loss Account;
- explain the Balance Sheet as per format;
- appreciate the marshalling of Balance Sheet;
- classify the assets and liabilities and
- prepare Balance Sheet.

17.1 PREPARATION OF TRADING ACCOUNT AND PROFIT AND LOSS ACCOUNT

You have already learnt the meaning and format of Trading Account and Profit and Loss Account. You have also learnt how to make journal entries to transfer relevant ledger balances to Trading Account and Profit and Loss Account. Now, you will learn the various steps to be followed in preparing these statements.



Notes

Steps to be followed while preparing Trading Account

A. Debit side

(i) We post the amount of opening stock (In case of a new firm there will not be any opening stock).

(ii) We post the amount of purchases Out of this, purchases returns or returns outward is deducted. Purchases may be cash or credit or both.

(iii) Then we post the direct expenses such as carriage inward, wages, power, etc.

B. Credit side

(i) We post sales. Sales return or returns inward is deducted from the sales to get the net sales figure. Sales may be cash or credit or both.

(ii) Closing stock is the next item.

C. Ascertaining Gross Profit/Gross Loss

Finally, Trading Account is closed by calculating the difference of the two sides. If credit side exceeds the debit side, the difference is written as Gross Profit on the debit side of the Trading A/c. In case debit side is more than the credit side, the difference amount is termed as 'Gross Loss' and is shown on the credit side of the Trading A/c.

Total of Debit column $<$ Total of credit column

$\Rightarrow$ Gross profit

Total of credit column $<$ Total of debit column

$\Rightarrow$ Gross loss

Steps to be followed while preparing Profit and Loss Account

A. Debit side

(i) Gross Loss, if any, transferred from Trading A/c is written as the first item.

(ii) Next all items of revenue expenses and losses are written. These items may be salaries, rent paid, depreciation, etc.

B. Credit side

1. Gross Profit transferred from Trading A/c is the first item.

2. Next all items of revenue incomes and gains are written. These may be interest on investments, discount received, commission received, etc.

C. Ascertaining Net Profit/Net Loss

The next step is to get the balance. If credit side is more than the debit side the difference in amount is shown as Net Profit. If debit side exceeds the credit side, the difference is Net Loss. This amount is transferred to Capital Account.

Notes

Total of Debit side < Total of credit side

⇒ Net profit

Total of credit side < Total of debit side

⇒ Net loss

Illustration 1

From the following information of M/s Nand Lal & Bros. for the year ending 31st March, 2014 prepare Trading A/c and Profit and Loss A/c for the year ended 31st March, 2014.

	₹		₹
Stock 1.4.2013	5,800	Sales	72,000
Purchases - cash	42,000	Return Inward	2,000
Purchases - credit	18,000	Interest on Investment	1,500
Freight Inward	1,800	Discount Received	1,200
Wages	4,500	Closing stock (31.3.2014)	7,200
Carriage on Sales	800		
Telephone Charges	1,600		
Electricity Expenses	1,200		
Office Rent Paid	6,000		
Salaries	8,000		
Depreciation	1,400		

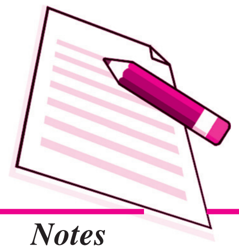
Solution :

Books of M/s Nand Lal & Bros.

Trading A/c
for the year ended 31st March, 2014

Dr. Cr.

Particulars		*Amount* ₹	*Particulars*		*Amount* ₹
Stock (1.4.2013)		5,800	Sales	72,000	
Purchases			*Less:* Return Inward	2,000	70,000
Cash	42,000		Closing stock (31.3.2014)		7,200
Credit	18,000	60,000			



Notes

Freight Inward	1,800		
Wages	4,500		
Gross profit transferred to			
Profit and Loss A/c	5,100		
	77,200		77,200

Profit and Loss A/c
for the year ending 31st March, 2014

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
Carriage on sale	800	Gross Profit transferred	
Telephone charges	1,600	from Trading A/c	5,100
Electricity Expenses	1,200	Interest on Investment	1,500
Office Rent	6,000	Discount Received	1,200
Salaries	8,000	Net Loss transferred	
Depreciation	1,400	to capital A/c	11,200
	19,000		19,000

Illustration 2

Prepare Trading A/c and Profit and Loss A/c of Raman Irani from the following balances for the year ending 31st March, 2014.

	₹		₹
Opening Stock (1.4.2013)	14,600	Trading Expenses	1,450
Purchases	68,700	Discount allowed	1,250
Sales	85,300	Discount Received	800
Return outward	2,200	Bill Receivables	4,500
Carriage Inward	2,100	Debtors	16,800
Capital	50,000	Closing stock (31.3.2014)	28,700
Drawings	12,000		
Insurance	1,600		
Advertisement	2,400		
Salesmen's Salaries	5,200		

Notes

Solution :

Books of Raman Irani
Trading A/c
for the year ending 31st March, 2014

Dr. Cr.

Particulars		*Amount* ₹	*Particulars*	*Amount* ₹
Opening Stock		14,600	Sales	85,300
Purchases	68,700		Closing stock	28,700
Less Return outward	2,200	66,500		
Carriage Inward		2,100		
Gross profit transferred to				
Profit and Loss A/c		30,800		
		1,14,000		1,14,000

Profit and Loss A/c

for the year ended 31st March, 2014

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Insurance	1,600	Gross Profit transferred	
Advertisement	2,400	from Trading A/c	30,800
Salesmen's salaries	5,200	Discount Received	800
Trading Expenses	1,450		
Discount allowed	1,250		
Net Profit transferred to			
capital A/c	19,700		
	31,600		31,600

INTEXT QUESTIONS 17.1

Write the name of the Account (Trading A/c, Profit & Loss A/c) and the side (debit/credit) against the items given below to which these are posted:

(i) Closing stock ....

(ii) Carriage outward ....

Notes

(iii) Interest on Investment	....	....
(iv) Custom duty .	....	....
(v) Fuel & Power	....	....
(vi) Sales	....	....
(vii) Salaries	....	....
(viii) Rent from tenant	....	....

17.2 BALANCE SHEET

Apart from Trading Account and Profit and Loss Account, Balance Sheet is another financial statement that is prepared by every business firm. Balance sheet is a statement which shows the financial position of a business organisation on a particular date which is generally the last date of the accounting period. Financial position of a business unit is the amount of claims against the resources of business. These resources are cash, stock of goods, furniture, machinery, etc. The claims include the claims of the owner capital and the claims of outsiders such as creditors, bankers, etc. Therefore, it can be stated that Balance Sheet is the statement which shows assets owned by the business and liabilities owed by it on a particular date. Balance Sheet is not an account. It has two sides. (i) Assets side and (ii) the Liabilities side. The Asset side has a list of fixed as well current assets. The liabilities side has a list of items of capital, long term as well as short term liabilities.

Need

1. Balance Sheet is prepared to measure the true financial position of a business entity at a particular point of time.
2. It is a systematic presentation of what a business unit owns and what it owes.
3. Balance Sheet shows the financial position of the concern at a glance.
4. Creditors, financiers are particularly interested in the Balance Sheet of a concern so that they can decide whether to deal with the concern or not.

Grouping of Assets and Liabilities

All the assets can be categorised in following groups :

1. Current Assets
2. Liquid Assets
3. Non-current Assets
4. Tangible Assets
5. Intangible Assets

All the liabilities can be catagorised in two groups :

1. Current Liabilities
2. Non-current Liabilities

Marshalling of Assets and Liabilities

As stated above Balance sheet has two sides i.e. Assets side, which has various items of assets of the concern and liabilities side which has the liability or claim of the owner as well as of the outside parties.

Assets refer to the financial resources of the business and can broadly be divided into Current Assets and Fixed Assets, Liabilities denote claims against the assets of the business. Liabilities can be of two types owners liability or capital and outsiders liabilities such as creditors, bills payable, Bank Loan etc.

There is no prescribed form in which a Balance Sheet should be prepared by a sole proprietary business or a partnership firm. However, an order is generally maintained in which assets and liabilities are written. This is to maintain uniformity/consistency which facilitates comparative analysis for decision making. Balance sheet may be prepared in any of the following orders :

(a) Liquidity order (b) Permanency order

(a) Liquidity Order

Liquidity means convertibility of assets into cash. Every asset cannot be converted into cash at the same degree of ease and convenience. Assets are written in the order of their liquidity, Assets of highest liquidity is written first and next highest follows and so on. Similarly, liabilities are also written in this very order. Short term liabilities are written first and then long term liabilities and lastly the capital.

A specimen of the balance sheet prepared in order of liquidity is given below:

Balance Sheet of M/s ....
as at ....

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Bank overdraft	xxxx	Cash in hand	xxxx
Outstanding Expenses	xxxx	Cash at bank	xxxx
Bill payables	xxxx	Prepaid expenses	xxxx
Sundry creditors	xxxx	Investments (short term)	xxxx
Loans	xxxx	Bill Receivables	xxxx
Capital	xxxx	Sundry Debtors	xxxx
Add Net Profit	xxxx	Closing stock	xxxx

Notes

Less drawings		xxxx	Investments	xxxx
			Furniture	xxxx
			Plant & Machinery	xxxx
			Land & Building	xxxx
			Goodwill	xxxx
		xxxx		xxxx

(Investments on short term basis are marketable securities; they form part of current assets.)

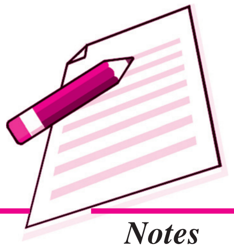
(b) Permanency order

While following the order of permanency, assets, which are to be used permanently i.e. for a long time and not meant for resale are presented first. For example, Land and Building, Plant and Machinery, furniture etc. are written first. Assets which are most liquid such as cash in hand is written in the last. Order of liabilities is similarly changed. Capital is written first, then the long term liabilities and lastly the short term liabilities and provisions. Specimen of a Balance Sheet that can be prepared in the order of permanency is as follows :

Balance sheet of M/s ....

as at ....

Liabilities		*Amount* ₹	*Asset*	*Amount* ₹
Capital	xxxx		Goodwill	xxxx
Add : Net profit	xxxx		Land & Building	xxxx
Less : Drawings	xxxx	xxxx	Plant & Machinery	xxxx
Loans		xxxx	Furniture	xxxx
Sundry creditors		xxxx	Investments	xxxx
Bills payable		xxxx	Closing stock	xxxx
Outstanding expenses		xxxx	Sundry Debtors	xxxx
Bank overdraft		xxxx	Bills Receivables	xxxx
			Investments (short term)	xxxx
			Prepaid expenses	xxxx
			Cash at bank	xxxx
			Cash in hand	xxxx
		xxxx		xxxx



[In case of joint stock companies balance sheet is prepared as per schedule VI of the Companies Act 1956]

Illustration 3

From the balances given below prepare Balance sheet of M/s Bharat & Bros as on 31st December, 2014. In (a) liquidity order and, (b) in permanency order.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Capital	50,000	Sundry Debtors	24,000
Loan from Bank	20,000	Bills Payable	8,000
Cash in hand	2,500	Drawings	6,000
Cash at Bank	12,800	Building	25,000
Closing stock	24,700	Furniture	4,500
Sundry creditor	15,000	Investments	15,000
		Net Profit	21,500

Solution :

A. Liquidity order

Balance sheet of M/s Bharat & Bros
as on 31st Dec., 2014

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Bills Payable		8,000	Cash in hand	2,500
Sundry creditors		15,000	Cash at Bank	12,800
Loan from Bank		20,000	Sundry Debtors	24,000
Capital	50,000		Closing stock	24,700
Add : Net Profit	21,500		Investments	15,000
	71,500		Furniture	45,00
Less : drawings	6,000	65,500	Building	25,000
		1,08,500		1,08,500

B. In permanency Order

Balance sheet of M/s Bharat & Bros
as on 31st Dec., 2014

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Capital	50,000		Building	25,000
Add Net Profit	21,500		Furniture	4,500
Less drawings	6,000	65,500	Investments	15,000

Loan from Bank	20,000	Closing stock	24,700
Sundry creditors	15,000	Sundry Debtors	240,00
Bills payable	8,000	Cash at Bank	12,800
		Cash in hand	2,500
	1,08,500		1,08,500

Notes

INTEXT QUESTIONS 17.2

I. Arrange the following Assets in (i) Liquidity order (ii) Permanency order.

(i) Closing stock (ii) Furniture

(iii) Cash in hand (iv) Investments

(v) Bills Receivable (vi) Goodwill

(vii) Building (viii) Debtors

II. Arrange the following items of liabilities in (i) Liquidity order and (ii) in permanency order

(i) Bills Payable (ii) Sundry Creditors

(iii) Loan on Mortgage (iv) Outstanding Expenses

(v) Capital

17.3 CLASSIFICATION OF ASSETS AND LIABILITIES

Assets and Liabilities are of various types. These can be classified as under:

Assets

Assets can be classified as follows :

(a) **Fixed Assets :** These are the assets that are purchased on permanent basis i.e. for long term use and help the business to earn revenue. Examples of such assets are Building, Machinery, Motor Vehicle, etc. These assets are not for sale in ordinary course of business but can be disposed off, if no more needed for business use.

(b) **Current Assets :** These are the assets which are acquired by the business either for resale or for converting them into cash. These are normally realised within a period of one year. Examples of such assets are : cash in hand, cash at bank, bill receivable, debtors, stock etc.

(c) **Tangible Assets :** These are the assets that can be seen, touched and have certain volume. Building, Machinery, goods etc. are tangible assets.

(d) **Intangible Assets :** Assets which can neither be seen nor touched and have no volume are called intangible assets. Patents, trademark, goodwill etc are the examples of such assets.

(e) **Liquid Assets :** These are the assets which are either in cash or can be easily converted into cash. For example cash, stock, marketable securities etc.

(f) **Wasting Assets :** These are the assets which exhaust or reduce in value by their use. Mines, quarries etc come under this category.

(g) **Fictitious Assets :** These are not the real assets. These are the items of such expenses and losses which have not been written off in full. For example, preliminary expenses, underwriting commission, etc.

Notes

Liabilities

Liabilities can be classified as follows :

(a) **Long term Liabilities :** These are the liabilities which are not payable during the current accounting year. Generally, the funds raised through such means are used for purchase of fixed assets. Examples of such liabilities are loan on mortgage, loan from financial institutions.

(b) **Current Liabilities :** These are the liabilities which are payable during the current year. These include Bank overdraft, trade creditors, bill payable etc.

(c) **Owners' Funds :** The amount owing to the proprietor or proprietors is called owners' funds. As per business entity concept this is a liability of the business. Apart from capital it also includes undistributed profits and reserves. Amount of drawings by the proprietor is deducted from it.

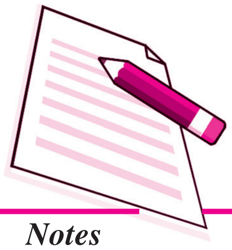
INTEXT QUESTIONS 17.3

I. Write the type of assets against the items given below :

(i)	Goodwill	(ii)	Bills Receivable
(iii)	Preliminary Expenses	(iv)	Mines
(v)	Furniture		

II. Write the type of liabilities against the items given below :

(i)	Loan on mortgage	(ii)	Creditors
(iii)	Outstanding expenses	(iv)	Capital



Notes

17.4 PREPARATION OF BALANCE SHEET

Balance sheet has two sides : Assets and Liabilities. On the assets side we present all types of assets such as Cash, Bills Receivable, Stock, Building etc.

On the liabilities side all liabilities, both long term liabilities and current liabilities are presented, such as Bills Payable, trade creditors, bank loan etc. Next we write owners' capital. Net profit is added to it. If there is net loss it is deducted from the capital. Amount of drawings is also deducted from the capital. Finally the two sides are totalled and the totals should agree.

Illustration 4

From the following Trial Balance of M/s Vikram Brothers prepare Trading and Profit and Loss Account for the year ended 31st March 2014 and Balance Sheet as on that date.

Particulars	*Dr. Balances ₹*	*Particulars*	*Cr. Balance ₹*
Cash in hand	500	Capital	70,000
Motor car	25,000	Discount Received	2,000
Drawings	48,000	Sales	2,30,000
Legal charges	1,500	Creditors	46,000
Plant & Machinery	60,000	Interest on investment	5,200
Investments	40,000	Purchases Return	3,800
Opening stock	35,000	Bills payable	34,000
Sales Returns	2,500		
Salaries	12,000		
Discount allowed	600		
Carriage Inward	1,800		
Wages	21,000		
Postage	400		
Debtors	60,000		
Interest	1,500		
Insurance Premium	1,200		
Purchases	80,000		
	3,91,000		3,91,000

Notes

Closing stock as on 31.3.2014 ₹28,000

Solution :

Trading A/c
for the year ended 31st March, 2014

Dr. Cr.

Particulars		*Amount* ₹	*Particulars*		*Amount* ₹
Opening stock		35,000	Sales	2,30,000	
Purchases	80,000		Less sales Returns	2,500	2,275,00
Less purchase return	3,800	76,200	Closing stock		28,000
Wages		21,000			
Carriage Inward		1,800			
Gross Profit transferred					
to Profit & Loss A/c		1,21,500			
		2,55,500			2,55,500

Profit & Loss A/c
for the year ended 31st March, 2014

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Salaries	12,000	Gross Profit transferred	
Insurance Premium	1,200	from Trading A/c	1,21,500
Discount allowed	600	Discount Received	2,000
Postage	400	Interest on Investments	5,200
Interest	1,500		
Legal charges	1,500		
Net Profit Transferred			
to Capital A/c	1,11,500		
	1,28,700		1,28,700

Balance Sheet
As on 31st March, 2014

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Bills Payable	34,000	Cash in hand	500
Creditors	46,000	Debtors	60,000

Notes

Capital	70,000		Closing stock	28,000
Add : Net Profit	1,11,500		Investments	40,000
	1,81,500		Motor car	25,000
Less : Drawings	48,000	1,33,500	Plant & Machinery	60,000
		2,13,500		2,13,500

Illustration 5

Following is the Trial Balance extracted from the books of Jasmine Enterprises as on 31st March, 2014. Prepare Trading and Profit & Loss A/c from the information given in Trial Balance for the year ending 31st March, 2014. Also prepare the Balance Sheet as on that date.

Particulars	*Dr. Amount (₹)*	*Cr. Amount (₹)*
Stock (1.4.2013)	18,500	
Purchases & Sales	78,500	1,54,200
Return Inwards & Return Outwards	2,200	2,500
Debtors & Creditors	16,500	18,000
Bills Receivable & Bills Payable	14,000	21,000
Commission paid	2,000	
Audit fees	1,800	
Building	65,000	
Furniture	12,000	
Salaries	14,000	
Telephone charges	4,200	
Insurance	2,100	
Discount allowed	1,000	
Octroi	1,200	
Wages	16,000	
Freight Inward	2,400	
Bad debts	600	
Depreciation	4,200	
Bank loan		32,000
Cash in hand and at Bank	25,000	

Capital		1,00,000
Drawing	16,500	
Machinery	30,000	
	3,277,00	3,27,700

Stock as on 31.3.2014 ₹ 19,600

Solution :

Trading A/c
For the year ended 31st March, 2014

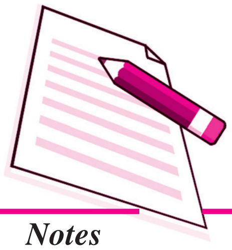
Dr. Cr.

Particulars		*Amount* ₹	*Particulars*		*Amount* ₹
Stock (1.4.2013)		18,500	Sales	1,54,200	
Purchases	78,500		Less Return Inward	2,200	152000
Less return outward	2,500	76,000	Closing stock		19,600
Wages		16,000			
Freight Inward		2,400			
Octroi		1,200			
Gross Profit transferred					
to Profit & Loss A/c		57,500			
		1,71,600			1,71,600

Profit & Loss A/c
for the year ended 31st March, 2014

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Salaries	14,000	Gross Profit transferred	
Telephone Charge	4,200	from Trading A/c	57,500
Insurance Premium	2,100		
Bad debts	600		
Depreciation	4,200		
Audit fees	1,800		
Discount allowed	1,000		
Commission paid	2,000		
Net Profit Transferred			
to Capital A/c	27,600		
	57,500		57,500

Notes



Notes

Balance Sheet
as at 31st March, 2014

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Bills Payable		21,000	Cash in hand & at Bank	25,000
Sundry creditors		18,000	Bill receivable	14,000
Bank Loan		32,000	Sundry Debtors	16,500
Capital	1,00,000		Closing stock	19,600
Add : Net Profit	27,600		Furniture	12,000
	1,27,600		Machinery	30,000
Less : Drawings	16,500	1,11,100	Building	65,000
		1,82,100		1,82,100

Illustration : 6

From the following balances extracted from the books of Hari on 31st March, 2014, prepare his Trading and Profit and Loss Accounts and Balance Sheet :

Trial Balance

	₹		₹
Opening Stock	9,600	Repairs to Plant	160
Wages and Salaries	3,200	Cash in Hand and at Bank	200
Commission on Purchases	200	Debtors	4,000
Freight	300	Income-Tax	550
Purchases *less* Returns	11,850	Drawings	650
Sales *less* Returns	24,900	Capital	5,000
Trade Expenses	20	Bills Payable	500
Bills Receivable	600	Loan	900
Rent	200	Discount on Purchases	400
Plant	2,000	Creditors	2,330
Bad Debts	500		

Information : Stock at the end was ₹ 3,500

Solution :

Trading and Profit & Loss Account
Dr. ***for the year ending 31st March, 2014*** Cr.

Particulars	₹	*Particulars*	₹
To Opening Stock	9,600	By Sales *less* Returns	24,900
To Purchases *less* Returns	11,850	By Closing Stock	3,500

Notes

To Wages and Salaries	3,200		
To Commission on Purchases	200		
To Freight	300		
To Gross Profit *c/d*	3,250		
	28,400		28,400
To Trade Expenses	20	By Gross Profit *b/d*	3,250
To Rent	200	By Discount on Purchases	400
To Bad Debts	500		
To Repairs to Plant	160		
To Net Profit transferred to Capital A/c	2,770		
	3,650		3,650

Balance Sheet of Hari
as at March 31, 2014

Liabilities			₹	*Assets*	₹
Capital				Plant	2,000
Opening Balance		5,000		Stock at the end	3,500
Add : Net Profit		2,770		Debtors	4,000
		7,770		Bills Receivable	600
Less: Income Tax	550			Cash-in-Hand and at Bank	200
Drawing	650	1,200	6,570		
Loan			900		
Bills Payable			500		
Creditors			2,330		
			10,300		10,300

INTEXT QUESTIONS 17.4

Fill in the blanks with appropriate word/words :

(i) The amount by which credit side of Trading A/c exceeds the debit side is known as ....

(ii) The amount by which debit side exceeds the credit side of Profit & Loss A/c is shown as ....

(iii) The totals of the two sides of the Balance sheet should always be ....

(iv) Bank loan is shown on the .... side of the Balance sheet.

Notes

WHAT YOU HAVE LEARNT

- To prepare Trading Account, on the debit side we present opening stock, net purchases and direct expenses on the credit we present net sales and closing stock. The difference of the two sides is found out which may be Gross Profit or Gross Loss. The same is transferred to Profit & Loss Account.
- All items of revenue expenditure and losses are shown on the debit side of Profit and Loss Account and on the credit are shown items of revenue receipts and gains. The difference of the two sides is calculated which may be either Net Profit or Net Loss.
- Balance sheet is a statement showing the financial position of a business unit on the last date of the accounting year.
- Balance sheet is a systematic presentation of what a business unit owns and what it owes.
- Balance sheet has two sides Assets and Liabilities.
- Assets and Liabilities may be written in (i) Liquidity order or (ii) Permanency order.
- Assets may be classified as : fixed assets, current assets, tangible assets, intangible assets, liquid assets, wasting assets and fictitious assets.
- Liabilities can be long term liabilities, current liabilities and owners funds.

TERMINAL EXERCISE

1. State the steps for preparing Trading Account.
2. Explain the term Balance Sheet. Also explain the objectives of preparing a Balance sheet.
3. List assets in 'liquidity order' and 'permanency order' in a Balance Sheet.
4. Explain the following types of assets with two examples each :

   (a) Intangible Assets (b) Fictitious Assets

   (c) Fixed Assets (d) Current Assets
5. What are owners' funds ?
6. From the following information extracted from the books of P. Mukherjee, prepare Trading Account for the year ending 31st March, 2014.

	₹		₹
Opening stock	6,500	Cash	4,500
Purchases	45,000	Office expenses	3,200
Sales	72,000	Office Rent	6,800
Return Inward	1,500		
Return Outward	500		
Carriage on Purchases	1,200		
Wages	4,800		
Fuel & Power	3,200		

Closing stock on 31st March, 2014 was ₹ 8,600

Notes

7. From the following information of Rashmi prepare Profit & Loss Account for the year ending 31st March, 2014.

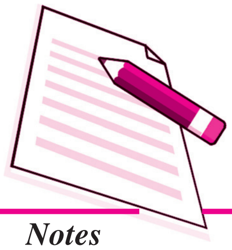
	₹		₹
Gross Profit	64,800	Discount Received	600
Bad debts	1,500	Commission Received	2,100
Depreciation	2,500	Freight outward	1,600
Office rent	4,800	Prepaid Insurance	600
Insurance	3,200	Salary	6,400
Telephone charges	1,700	Stationery	700
Interest on loan	2,400	Furniture	6,000
Building	50,000		

Closing stock as on 31st March, 2014 ₹ 20,000

8. From the following Trial Balance of M/s Krishna Murthi Garments as on 31st March, 2014, you are required to prepare Trading Account, Profit and Loss A/c for the year ended 31st March, 2014 and a Balance sheet as on that date.

Trial Balance of M/s Krishna Murthi Garments
as at 31st March, 2014

Particulars	*Dr. Balances ₹*	*Cr. Balances ₹*
Cash in hand	2,000	
Bank overdraft		35,000



Notes

Stock (1.4.2013)	32,000	
Purchases	80,000	
Freight Inward	4,000	
Custom duty	5,500	
Power	6,500	
Machines	40,000	
Furniture	20,000	
Sales		1,65,000
Bills Payable		18,000
Sundry Debtors	28,000	
Sundry creditors		22,000
Salaries	6,500	
Salesmen's commission	7,800	
Rent of Godown	7,200	
Insurance	2,400	
Land & Building	75,000	
Carriage on sales	3,600	
Advertisement	4,500	
Capital		1,00,000
Drawings	15,000	
	3,40,000	3,40,000

Closing stock as on 31st March, 2014 ₹ 38,000

9. Rakesh carries on business as a furniture manufacturer. Prepare his Trading and Profit & Loss Acount and Balance Sheet from the following balances as on 31st March, 2014 :

	₹		₹
Capital	6,000	Polishing	500
Withdrawals (Drawings)	1,000	Rates and Taxes	40
Sales	10,000	Bills Receivable	300
Raw material (Purchased)	2,000	Insurance	150

Loan or Mortgage (Cr.)	1,000	Carriage	10
Machinery	1,500	Incidental Expenses	200
Land and Building	2,000	Stock, 1st April, 2013	2,000
Creditors	500	Cash at Bank	1,250
Wages	5,000	Cash in Hand	50
Debtors 1,500			

Stock on 31st March, 2014, ₹ 1,500.

10. The following balances were extracted from the books of Harish Jalal on 31st March, 2014 :

	₹		₹
Capital	24,500	Loan	7,880
Drawings	2,000	Sales	65,360
General Expenses	2,500	Purchases	47,000
Buildings	11,000	Motor Car	2,000
Machinery	9,340	Reserve Fund (Cr.)	900
Stock	16,200	Commission (Cr.)	1,320
Power	2,240	Car Expenses	1,800
Taxes and Insurance	1,315	Bills Payable	3,850
Wages	7,200	Cash	80
Debtors	6,280	Bank Overdraft	3,300
Creditors	2,500	Charity	105
Bad Debts	550		

Stock on 31st March, 2014 was valued at ₹ 23,500.

ANSWERS TO INTEXT QUESTIONS

17.1 (i) Trading A/c credit

(ii) Profit & Loss A/c debit

(iii) Profit & Loss A/c credit

(iv) Trading A/c debit

Notes

	(v)	Trading A/c	debit
	(vi)	Trading A/c	credit
	(vii)	Profit & Loss A/c	debit
	(viii)	Profit & Loss A/c	credit

17.2 I.

Liquidity order	***Permanency order***
Cash in hand	Goodwill
Bills Receivable	Furniture
Sundry Debtors	Building
Closing stocks	Investments
Investments	Closing stock
Furniture	Sundry Debtors
Building	Bills Receivable
Goodwill	Cash in hand

II.

Liquidity order	***Permanency order***
Outstanding expenses	Capital
Bills payable	Loan on Mortgage
Sundry Creditors	Sundry Creditors
Loan on Mortgage	Bill payable
Capital	Outstanding expenses

17.3 I. (i) Intangible Asset (ii) Current Asset (iii) Fictitious Asset
(iv) Wasting Asset (v) Fixed Asset

II. (i) Long term liability (ii) Current liability
(iii) Current liability (iv) Owner fund

17.4 (i) Gross Profit (ii) Net Loss (iii) Equal (iv) Liabilities

ANSWERS TO TERMINAL EXERCISE

6. Gross profit ₹ 10,300
7. Net Profit ₹ 42,700
8. Gross Profit ₹ 75,000

Net Profit ₹ 44,000

Total of Balance Sheet ₹ 2,03,000

9. Gross Profit ₹ 1,790

Net Profit ₹ 1,600

Total of Balance Sheet ₹ 8,100

10. Gross Profit ₹ 16,220

Net Profit ₹ 11,270

Total of Balance Sheet ₹ 52,200

ACTIVITIES

1. Visit some business firms of your locality, parents of your friends and of your relatives and collect the information about assets which are not common because of the nature of their business and classify them into relevant categories.

Name of the firm	*Nature of business*	*Name of the asset*	*Category of the asset*
1.			
2.			
3.			
4.			
5.			

2. Analyse the Balance Sheet of a business enterprise being run by your father/father of your friend or by a relative and check the marshalling of Assets and Liabilities. If these are not in order place them in liquidity order or permanency order. If these are already in liquidity order place them in permanency order and vice-versa.

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18

FINANCIAL STATEMENTS - II

You have learnt that Income Statement i.e. Trading & Profit and Loss Account and Position Statement i.e., Balance Sheet are two financial statements, which are prepared by every business concern at the end of a period. Income statement shows the Net Profit or Net loss as the case may be for that period and Position Statement presents the financial position of the business on the specific date. These statements are prepared on the basis of Trial Balance and other information. It is possible that there are certain items of income or expenses which do not pertain to the accounting period for which Trial Balance is prepared or other such items which have accrued but have not been accounted for and hence are not reflected in Trial Balance. Both these types of incomes and expenses are to be fully accounted for, only then the above stated two statements will show the true and fair position of the business. These are called 'adjustments'. In this lesson we shall learn about accounting treatment of some of the adjustments and incorporation of these adjustments in financial statements.

OBJECTIVES

After studying this lesson you will be able to:

- recognise the need for accounting adjustments;
- explain the adjustments as to closing stock, outstanding and pre-paid expenses, accrued income and income received in advance;
- interest on capital and drawings, depreciation, provision for bad and doubtful debts; and
- incorporate the adjustments in Trading Account, Profit & Loss Account and Balance Sheet.

Notes

18.1 NEED FOR ACCOUNTING ADJUSTMENTS

You have already learnt that every business entity prepares Trading and Profit & Loss Account and Balance Sheet, the two financial statements, at the end of an accounting period which is generally one year. It needs to be ensured that such items of income and expenditure which do not pertain to the said accounting period, should not to be included. If some of these items have been included in the trial balance these must be excluded by making necessary adjusting entry. Similarly, there can be items which are left out and are needed to be accounted for. Adjustment entry will also be made for them. This is necessary in order to calculate the correct profit or loss and to show true and fair financial position of the business. For example, a firm closes its books on March 31, every year, Suppose it has not paid rent of the shop for the month of March. This will not be reflected in Trial Balance and hence it needs to be accounted for as it relates to the year for which accounts are being prepared. Similarly, suppose annual insurance premium has been paid up to June, 30. It means premium for three months has been paid in advance. This is included in the item of insurance appearing in the Trial Balance. This amount paid in advance needs to be excluded. This process of exclusion or inclusion of items into books of accounts at the time of preparing finanacial statements is called adjustments. These are to be incorporated to arrive at the true and fair position of the business.

INTEXT QUESTIONS 18.1

Fill in the blanks with suitable word/words :

(i) Trading and Profit & Loss Account shows the .... or ....

(ii) Adjustments are necessary to show the correct .... and .... of a business concern.

(iii) Items of income and expenditure which do not pertain to the accounting period should be ....

(iv) Items of income & expenditure which relate to the accounting period but are left out should be ....

18.2 ADJUSTMENTS AND THEIR INCORPORATION

The number and nature of adjustments differ from organisation to organisation. It depends upon the volume and nature of activities in the organisation, However, certain adjustments are common in all types of organisations. Moreover, while making adjustments you will have to follow the general principle of double entry i.e. the amount is to be debited to one account and credited to another account. Thus in the finanacial statements the item to be adjusted should appear at two places one representing the debit and the other representing the credit.

Notes

Let us, now discuss some of the items of adjustment and their accounting treatment in financial statements. These are as under :

1. Closing Stock
2. Outstanding Expenses.
3. Prepaid Expenses
4. Accrued Income.
5. Income received in advance
6. Interest on Capital
7. Interests on Drawings
8. Depreciation.
9. Further Bad Debts.
10. Provision for Bad and Doubtful Debts.
11. Provision for discount on debtors.
12. Managers Commission
13. Abnormal losses.
14. Drawing of Goods by the Proprietor.
15. Goods Distributed as free Sample.

Let us take up these adjustments one by one:

1. Closing Stock

Closing Stock is the stock of goods remaining unsold at the end of the accounting year. Ordinarily this does not appear in the Trial Balance. Hence, this needs to be incorporated in financial statements. This appears on the credit side of the Trading Account as well as Assets side of the Balance Sheet.

The adjustment entry will be:

Closing Stock A/c Dr

To Trading A/c

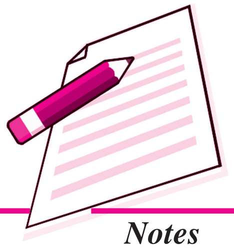
(Closing stock transferred to trading A/c)

The effect of the adjustment entry on financial statements is as under :

Trading A/c

Dr Cr

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
		Closing stock	......



Notes

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
		Closing stock	....

In case closing stock has already been accounted for it will form part of the Trial Balance and hence there is no need of making any adjustments in the Trading A/c. Then the adjusted closing stock will be on the asset side of the Balance Sheet only.

2. Outstanding Expenses

Expense which is related to the current accounting period but not yet paid is known as Outstanding Expense. Suppose the accounts are closed on 31st December every year. Salary for the month of December is due but not paid. It is an example of salary outstanding. Similarly, there are some other items like Rent outstanding, Wages outstanding etc. In case of Salaries Outstanding following adjustment entry will be made :

Salary A/c Dr.

To Salary Outstanding A/c

(Salary outstanding for the month of December)

In financial statements it will be recorded as :

Profit & Loss A/c

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Salaries *Add :* Salary outstanding			

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Salary Outstanding			

Amount of expense outstanding will be added to its paid amount which is shown in the Trading A/c or Profit & Loss A/c as the case may be. It is also shown on the liabilities side of the Balance Sheet because it is an item of liabilities.

Notes

3. Prepaid Expenses

Sometimes a part of a certain expense paid may relate to the next accounting period. Such expenses is called prepaid expense or expenses paid in advance. For example, insurance premium paid in the current year may be for the year ending, the date of which falls in the next year. The part of insurance premium which relates to next accounting year is the insurance premium paid in advance. It is deducted from the amount paid and is shown as an item of asset. Similarly, such items may be rent prepaid, tax prepaid etc.

Adjustment entry for prepaid Insurance Premium

Prepaid Insurance Premium A/c Dr.

To Insurance Premium A/c

(Insurance premium paid in advance)

In financial statements, it is recorded as :

Profit & Loss A/c

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Insurance Premium *Less :* Prepaid Insurance premium			

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
		Prepaid insurance	

4. Accrued income (Due but not received)

Accrued income means income earned but not received till the end of the accounting year. For example, interest on securities or dividends on shares, which has become due but may be received on a date falling in the next year. Such income does not appear in the trial balance but should be duly accounted for in the year, because such income has accrued.

Adjustment entry for the transaction : suppose Rent receivable as it has become due but is not yet received

Rent Receivable (accrued) A/c Dr.

To Rent Received A/c

(Amount of rent due but not received)

In financial statements, it will be recorded as;

Profit & Loss A/c

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
		Rent Received *Add :* Rent Accrued	

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
		Rent Accrued	

5. Unearned income/income Received in Advance

Sometimes income is received before it becomes actually due. Such income is called "unearned income" or "income received in advance". Since this income does not relate to the accounting year, it should be deducted from the relevant head of income in the Profit & Loss A/c. It is a liability and hence is shown in the liability side of the Balance Sheet. Example of such income is rent that has been received for the months of January and February of the coming accounting year.

Adjustment entry for the same is

Rent Received A/c Dr

To Rent Received in Advance A/c

(Rent received in advance)

In financial statements

Profit and Loss A/c

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
		Rent Received *Less :* Rent received in advance	

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Rent received in advance			

Notes

INTEXT QUESTIONS 18.2

Fill in the blanks with suitable terms :

(i) Expenses related to the current accounting period but have not been paid are known as ....

(ii) Part of expenses paid if relates to the next accounting year, it is called ....

(iii) Income earned but not received till the end of the accounting year is termed as ....

(iv) Income if received before it becomes due is called ....

18.3 OTHER ADJUSTMENTS

6. Interest on Capital

As per business entity concept capital of the proprietor is a liability for the business. Like other loans, interest can be allowed on capital also. In case it is decided to allow interest on capital, adjustment entry will be as follows :

Interest on Capital A/c Dr

To Capital A/c

(Interest allowed on capital)

In financial statements it is shown as under:

Profit & Loss A/c

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Interest on capital			

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Capital *Add :* Interest on Capital			

7. Interest on Drawings

Interest may also be charged on money withdrawn by the proprietor for personal use. Following journal entry is made.

Capital A/c Dr.

To Interest on Drawings A/c

(Interest on Drawings charged)

In financial statements, it will be shown as :

Profit & Loss A/c

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
		Interest on Drawings	

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Capital *Less :* Interest on drawings			

8. Depreciation

The value of fixed assets such as Plant and Machinery, Furniture and Fixtures, Land & Building, Motor Vehicles etc. goes on reducing year after year due to wear and tear, obsolescence or for any other reason.

As the fixed assets are used for earning revenue the amount by which the value of a fixed asset decreases is an item of expense, similar to other expenses. This is called depreciation. It should be charged to the Profit and loss Account. The value of such assets should also be shown in the Balance Sheet at the reduced value by the amount of depreciation:

The adjustment entry for depreciation will be

Depreciation A/c Dr

To Asset (by name) Account

It will be shown in the Profit and Loss A/c and Balance sheet as under :

Profit & Loss A/c

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Depreciation on Plant & Machinery Motor Vehicle (etc)			

Balance Sheet

Liabilities	*Amount* ₹	*Assets*		*Amount* ₹
		Plant & Machinery	....	
		Less : Depreciation	....	....
		Motor Vehicle	....	
		Less: Depreciation	....	....

Note : In case amount of depreciation has been calculated before closing of accounts, it will appear in the debit column of the Trial Balance. It will be shown only on the debit of profit & Loss A/c and further adjustment is not required in the Balance Sheet.

9. Further Bad Debts

When the goods are sold on credit basis some of the debtors partly pay the due amount or do not pay at all. If this amount cannot be recovered it is called bad debts and is a loss to the firm. This is entered on the debit side of the Profit & loss A/c. But then there may be amount of bad debt which was not recorded in the books of accounts and hence did not appear in the Trial Balance. But the same was discovered before preparing the financial statements. It is called further bad-debts. Following adjustment entry is made for the same :

Bad Debts A/c Dr.

To Debtors A/c

(Further bad debts recorded)

In Profit and Loss A/c and Balance sheet it is shown as under :

Profit & Loss A/c

Dr Cr

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Bad Debts Add Further Bad debts			

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
		Sundry Debtors Less: Further Bad debts	

10. Provision for Bad and Doubtful debts

Some Debts of a particular year may become bad debts in the next year. It means the loss due to bad debts will be written off in the year it takes place instead of the year it belongs to. It will be a sound accounting practice that a suitable amount is kept aside in the current year to meet the possible loss of bad debts in the next year. Decision regarding maintenance for provision for Bad and Doubtful Debts is taken at the end of the year so it is an item of adjustment. It is called a provision for Bad and Doubtful Debt.

The adjustment entry will be as under :

Profit & loss A/c Dr.

To Provision for Doubtful Debts A/c

(Provision for doubtful debts created)

In the Profit and Loss A/c and Balance sheet it will be shown as under:

Profit & Loss A/c

Dr Cr

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Bad Debts *Add :* Provision for Doubtful debts			

Notes

Balance Sheet

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
		Debtors *Less :* Provision for bad Debts	

Such Provision is created on Debtors at a given rate say 5%. In case there is further bad debts, provision for bad and doubtful Debts will be calculated on the amount of debtors after deducting from it the amount of further Bad Debts.

Over the years businessman might have experienced that a certain percentage of the debts created due to credit sales go bad every year. So a provision for bad and doubtful debt is made on the debtors of a year at a fixed percentage say 5%. This percentage may change if the circumstances have changed. For example, it may be reduced if the businessman has become selective in selling goods on credit.

Provision for bad and doubtful debt is maintained at every year at a fixed percentage of the debtors. Last year balance is carried forward in the current year. This may be called old provision for bad and doubtful debts. Current years bad debts or/and further bad debts is adjusted towards this provision and more provision is created, which may be called new provision for bad debts.

Arithmatically it is shown in the Profit and Loss A/c as follows :

Profit and Loss A/c

Dr Cr

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Bad Debts *Add :* Further Bad Debts Add new provision for Bad and Doubtful Debts *Less :* Old provision for Bad and Doubtful Debts			

In case the balance amount of provision for bad and doubtful debts carried forward from last year is more than the amount of bad debts, amount of further Bad Debts and the amount of new provision for bad debts combined together, the excess balance will be credited to Profit and Loss A/c.

The amount of provision for Bad and Doubtful Debts is an item of liability. But usual practice is to show it as deducted from the amount of book debts/sundry debtors on the assets side of the Balance Sheet.

The above can best be explained by the following example :

Items appearing in the Trial Balance of a sole trader on 31st Dec, 2013.

Particulars	*Dr Balance ₹*	*Cr Balance ₹*
Sundry Debtors	24600	
Provision for Bad and Doubtful Debts		1000
Bad Debts	700	

Additional Information

Further bad debts amounted to ₹ 600. Make a provision for Bad and Doubtful debts on Debtors @ 5%.

Show the above items and related adjustments in the financial statements as on that date.

Proft and Loss A/c
for the year ended 31st Dec., 2013

Dr. Cr.

Particulars		*Amount ₹*	*Particulars*	*Amount ₹*
Bad Debts	700			
Further Bad Debts	600			
Add : New Provision for bad and Doubtful Debts	1200			
	2500			
Less : Old provision for bad and Doubtful Debts	(1000)	1500		

Balance Sheet
as on 31st Dec., 2013

Liabilities	*Amount ₹*	*Assets*		*Amount ₹*
		Sundry Debtors	24600	
		Less : Further Bad Debts	600	
			24000	
		Less : Provision for bad Debts @ 5%	1200	22800

18.4 ADJUSTMENTS IN PREPRATIONS OF FINANCIAL STATEMENTS

11. Provision for Discount on Debtors

Debtors outstanding at the end of year make payment in the next year and they may be entitled to cash discount if they make the payment by the due date. Because, the debt has arisen during the year, the discount is to be taken as expense for the year. Thus a Provision for Discount on Debtors is made.

The process is same as for the provision for doubtful debt. The likely amount of the discount to be allowed is debited to the Profit and Loss Account and credited to the Provision for Discount Account. This amount is deducted from book debts (debtors) in the balance sheet and is carried forward to the next year. Discount allowed to the existing debtors in the next year are debited to the Provision for Discount Account and not to the Profit and Loss Account. The debit reduces the balance in the provision account, it is made up to the required figure by a debit to the Profit & Loss Account and credit to the provisions account just like the Provision for Doubtful Debts Account.

An important point to note is that discount is not allowed on debts that became bad. Therefore, the provision for discount is made for good debts only. In other words, the amount of the Provision for Discount is calculated after deducting bad debts and the provision for doubtful debts from sundry debtros. Suppose, sundry debtors total ₹ 1,00,000; provision for doubtful debts is required at 5% and provision for discounts at 2.5%. So first we have to calculate provision for doubtful debts i.e. ₹ 1,00,000 x 5% = ₹ 5,000; the remaining amount is ₹ 95,000. Now we calculate Provision for Discount on Debtors i.e. ₹ 95,000 x 2.5% it will be ₹ 2,375.

Accounting Treatment

(i) For Discount Allowed :

Discount Allowed A/c Dr.

To Debtors A/c

(Being discount allowed to debtors)

(ii) For transferring the amount of discount to profit & loss Account.

Profit & Loss A/c Dr.

To Discount Allowed

(Being discount allowed transferred to Profit & Loss A/c)

Notes

(iii) If the existing provision appears in the books, then the discount allowed would be transferred to the Provision and Discount on Debtors Account instead of the Profit Loss Account. The entry would be :-

Provision for Discount on Debtors A/c Dr.

To Discount Allowed

(Being discount transferred to Provision for Discount on Debtors A/c)

(iv) For creating Provision for Discount on Debtors :

Profit and Loss A/c Dr.

To Provision for Discount on Debtors A/c

(Being balance of provision for discount account being charged to Profit & Loss A/c)

Illustration : 1

The Sundry Debts of a firm on 31st December, 2012 were ₹ 4,00,000. On that date, it was decided to create a Provision for Discount at 2% on Sundry Debtors. During 2013 the actual amount of discount allowed was ₹ 4000. The debtors on 31st December, 2013 were ₹ 3,00,000 and it was again decided to create a Provision for Discount over Debtors at 2%. Pass the Journal entries and prepare Discount Account and Provision for Discount Account for both the years.

Solution :

Journal

Date	*Particulars*	*L.F.*	*Dr. (₹)*	*Cr. (₹)*
2012				
Dec. 31	Profit and Loss A/c ...Dr.		8,000	
	To Provision for Discount on Debtors A/c			8,000
	(Being provision for discount on debtor credited)			
2013				
Dec. 31	Discount Allowed A/c ...Dr.		4,000	
	To Sundry Debtors A/c			4,000
	(Being discount allowed on payment received)			
Dec. 31	Provision for Discount on Debtors A/c ...Dr.		4,000	
	To Discount Allowed A/c			4,000
	(Being discount transferred to Provision Account)			
Dec. 31	Profit and Loss A/c ...Dr.		2,000	
	To Provision for Discount on Debtors A/c			2,000
	(Being provision created)			

Provision for Discount on Debtors Account

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2012				**2012**			
Dec. 31	To Balance c/d		8,000	Dec. 31	By Profit and Loss A/c		8,000
2013				**2013**			
Dec. 31	To Discount Allowed A/c		4,000	Jan. 1	By Balance b/d		8,000
Dec. 31	To Balance c/d		6,000	Dec. 31	By Profit and Loss A/c		2,000
			10,000				10,000
				2014			
				Jan. 1	By Balance c/d		6,000

Discount Allowed Account

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2013				**2013**			
Dec. 31	To Sundry Debtors A/c		4000	Dec. 31	By Provision for Discount A/c		4000

12. Manager's Commission

Sometimes, the manager is entitled to a commission on profits which is usually calculated as a fixed percentage of the profits. Suppose, the profit earned by the firm is ₹ 80,000 without considering the commission which is at 5%. The commission will be then ₹ 4,000. The profit will be reduced to ₹ 76,000. As the amount of commission ₹ 4,000 is still to be paid, it should be treated as an outstanding expense. Accordingly, the entry is:

Profit and Loss A/c ...Dr.

To Commission Payable or Outstanding Commission A/c

Commission Payable is a current liability and is shown in the Balance Sheet.

Sometimes, however, the commission is calculated on profits remaining finally after the commission. If the rate of the commission is 5%, and the profit remaining after the commission is ₹ 100; then the profit before the commission will be ₹ 105. That is in this case the commission of ₹ 5 should be out of every ₹ 105 of profit before the commission. The formula to calculate the commission in such a case is :

$$\frac{\text{Percentage of the commission}}{100 + \text{Percentage of the commission}} \times \text{Net Profit before charging the Commission}$$

If the profit before commission is ₹ 8,00,000 and the manager is entitled to a commission of 5% after deducting the commission, the amount will be ₹ 38,095, ₹ 8,00,000 of 5/105. This comission amount can be verified too. The profit after the commission is ₹ 7,61,905 and ₹ 38,095 is 5% of this figure. One can see that if we calculate it at 5% of ₹ 8,00,000 will be wrong since ₹ 40,000 is not 5% of ₹ 7,60,000.

Notes

Illustration : 2

The net profit of a firm amount to ₹ 1,05,000 before charging commission. The manager of the firm is entitled to a commission of Rs. 5% on the net profit. Calculate the comission payable to the manager under the following alternative cases :-

I. If the manager is allowed commission on the net profit before charging such commission, and

II. If the manager is allowed commission on the net profit after charging such commission. Also show the treatment in the final account ending on 31st March 2013.

Solution :

I Case

[Commission allowed on the net profit before charging such commission]

$$\text{Commission} = \text{Net Profit before charging the Commission} \times \frac{\%\text{ of Commission}}{100}$$

$$= ₹\,1{,}05{,}000 \times \frac{5}{100} = ₹\,5{,}250$$

Profit & Loss Account
for the year ended 31st March 2013

Particulars	₹	*Particulars*	₹
To Managers Commision	5,250		

Balance Sheet
as at 31st March 2013

Liabilities	₹	*Assets*	₹
Current Liabilities			
Manager's Com. Outstanding	5,250		

II Case

[Commission allowed on the net profit after charging such commission]

$$\text{Commission} = \text{Net Profit before charging the Commission} \times \frac{5}{105}$$

$$= ₹1,05,000 \times \frac{5}{105} = ₹5,000$$

Profit & Loss Account
for the year ended 31st March 2013

Particulars	₹	*Particulars*	₹
To Managers Commision	5,000		

Balance Sheet
as at 31st March 2013

Liabilities	₹	*Assets*	₹
Current Liabilities			
Manager's Com. Outstanding	5,000		

INTEXT QUESTIONS 18.3

I. Give exact term for the following:

(i) Provision against amount due from debtors.

(ii) Fall in the value of fixed assets due to wear and tear.

(iii) Debts which can not be recovered.

(iv) Stock of goods remaining unsold at the end of year.

II. Complete the journal entries for the following adjustments

(i) Interest on capital allowed

Interest on capital A/c Dr

To ……………..

(ii) Wages Outstanding

Wages A/c

To ………..

(iii) Insurance Premium paid for six months in advance

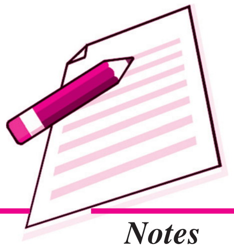
Unexpired Insurance A/c

To …………

(iv) Commission received but not yet earned

Commission A/c

To ………………..



Notes

III. State whether the following statements are True or False :

(i) Provision for discount on debtors is shown on the credit side of Profit & Loss A/c.

(ii) The Amount of Provision for discount on debtors is deducted from debtors.

(iii) Provision for discount on debtors is a income for a business.

(iv) Provision for discount on debtors is an asset for a company.

(v) If sundry debtors are of ₹ 10,000 and company creates provision for discount on debtors @ 10%. Then total provision is ₹ 1,000.

IV. Fill in the blanks with appropriate words :

(i) Manager's commission is shown in the ________ side of Profit & Loss A/c

(ii) Manager's commission is shown in the ___________ of Balance Sheet.

Illustration : 3

From the following Trial Balance of M.B. Garments as on 31st December, 2013, prepare Trading A/c and Profit & Loss A/c for the year ended 31st December, 2013 and Balance Sheet as on that date :

Name of the Account	*Dr. Amount* ₹	*Cr. Amount* ₹
Capital		80,000
Cash in hand	570	
Cash at bank	5,600	
Purchases	43,200	
Sales		78,000
Wages	10,400	
Power	4,730	
Carriage inward	2,040	
Carriage outward	3,200	
Stock (1.1.2006)	5,660	
Land & Building	40,000	
Machinery	20,000	
Salaries	4,000	

Insurance	600	
Sundry Debtors	28,000	
Sundry Creditors		10,000
	1,68,000	1,68,000

Following adjustments are to be accounted for:

(i) Stock on 31.12.2013 ₹ 10000.

(ii) Machinery to be depreciated @10% p.a. and Building to be depreciated @ 2% p.a.

(iii) Salaries for the month of December outstanding were ₹ 1200.

(iv) Insurance Premium was paid for one year ending 30th June, 2014.

Make journal entries for the adjustments and prepare Trading and Profit & loss A/c and the Balance Sheet.

Solution

Date	*Particulars*	*Dr. Amount ₹*	*Cr. Amount ₹*
2013			
Dec 31	Closing stock A/c ...Dr	10,000	
	To Trading A/c		10,000
	(Closing stock taken to Trading A/c)		
Dec 31	Depreciation A/c ...Dr.	2,800	
	To Machinery A/c		2,000
	To Land & Building A/c		800
	(Depreciation on machinery @ 10% p.a. and on land & Building @ 2% p.a.charged)		
Dec 31	Salaries A/c ...Dr.	1,200	
	To Salary Outstanding A/c		1,200
	(Salary due but not paid for December 2013)		
Dec 31	Prepaid Insurance A/c ...Dr.	300	
	To Insurance A/c		300
	(Insurance paid in advance accounted for)		

Notes

Trading A/c
for the year ended 31st Dec, 2013

Dr. Cr.

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Stock	5,660	Sales	78,000
Purchases	43,200	Closing stock	10,000
Wages	10,400		
Power	4,730		
Carriage Inward	2,040		
Gross Profit transferred to Profit & Loss A/c	21,970		
	88,000		88,000

Profit & Loss A/c
for the year ended 31st Dec. 2013

Dr. Cr.

Particulars		*Amount* ₹	*Particulars*	*Amount* ₹
Carriage outward		3,200	Gross Profit transferred from	
Salaries	4,000		Trading A/c	21,970
Add : Salary Outstanding	1,200	5,200		
Insurance	600			
Less : Prepaid insurance	300	300		
Depreciation on Machinery	2000			
Land & building	800	2,800		
Net Profit transferred to capital A/c		10,470		
		21,970		21,970

Balance Sheet
as at 31st Dec. 2013

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Salary Outstanding	1,200	Cash in hand	570
Sundry Creditors	10,000	Cash at Bank	5,600

Notes

Capital	80,000		Sundry debtors		28,000
Add: net profit	10,470	90,470	Closing stock		10,000
			Prepaid Insurance		300
			Land & Building	40,000	
			Less depreciation	800	39,200
			Machinery	20,000	
			Less depreciation	2,000	18,000
		1,01,670			1,01,670

Illustration : 4

From the following Trial Balance of Mustafa & Co., prepare Trading and Profit and loss A/c for the year ending on 31st Dec. 2013 and Balance Sheet as on that date after making necessary journal entries for adjustments.

	Dr. Balance (₹)		*Cr. Balance (₹)*
Land and Building	60,000	Capital	1,50,000
Plant and Machinery	40,000	Sundry Creditors	30,000
Bill Receivables	8,000	Sales	1,20,000
Stock on 1.1.2013	40,000	Reserve for Bad	4,500
Purchases	51,000	and Doubtful Debts	
Wages	20,000	Loan (12% p.a.)	10,000
Coal, Gas & Coke	5,800	Commission Received	2,000
Salaries	5,000		
Rent	2,800		
Cash at bank	25,000		
Sundry Debtors	45,000		
Repairs	1,800		
Bad Debts	5,500		
Sales Returns	2,000		
Furniture and Fixture	4,000		
Interest on Loan	600		
	3,16,500		3,16,500

Notes

Adjustments

1. Closing stock was valued at ₹ 30000.
2. Depreciate Plant & Machinery @ 5% and Furniture & Fixture @ 10%.
3. Provide for Bad and Doubtful Debts @ 5%.
4. Outstanding Wages ₹ 1000, Rent ₹ 500 and interest on loan outstandin ₹ 600.
5. Commission accrued ₹ 1000.

Solution.

Adjustment Entries

Date	*Particulars*		*Amount* ₹	*Amount* ₹
2013				
Dec 31	Closing Stock A/c	Dr.	30,000	
	To Trading A/c			30,000
	(Closing stock taken into account)			
	Depreciation A/c	Dr.	2400	
	To Plant & Machinery			2000
	To Furniture & Fixture			400
	(Depreciation charged @ 5% on Plant & Machinery & @10% on Furniture)			
	Profit & loss A/c	Dr.	2250	
	To Reserve for Doubtful Debts			2250
	(Reserve for Doubtful Debts created)			
	Wages A/c	Dr	1000	
	Rent A/c	Dr	500	
	To Outstanding Expenses A/c			1500
	(Outstanding expenses provided for)			
	Commission Accrued A/c	Dr.	1000	
	To commission received			1000
	(Commission accrued taken into consideration)			
	Interest on loan A/c	Dr	600	
	To Interest on loan Outstanding A/c		600	
	(Interest on loan due but not paid)			

Trading and Profit & Loss A/c of M/s Mustafa & Co.
for the year ended on 31.12.2013

Dr. Cr.

Particulars		₹	*Particulars*		₹
Opening Stock		40,000	Sales	1,20,000	
Purchases		51,000	*Less :* Sales Returns	2,000	1,18,000
Wages	20,000		Closing Stock		30,000
Add : Outstanding	1,000	21,000			
Coal, Gas & Coke		5,800			
Gross Profit c/d		30,200			
		1,48,000			1,48,000
Salaries		5,000	Gross Profit b/d		30,200
Rent	2,800		Commission Received		
Add : Outstanding	500	3,300	Received	2,000	
Repairs		1,800	*Add :* Accrued		
Bad Debts	5,500		Commission	1,000	3,000
Add : New Reserve	2,250				
	7,750				
Less : Old Reserve	4,500	3,250			
Interest on Loan	600				
Add : Interest Outstanding	600	1,200			
Depreciation					
Plant & Machinery	2,000				
Furniture & Fixture	400	2,400			
Net Profit Transferred to					
Capital A/c		16,250			
		33,200			33,200

Balance sheet of M/s Mustafa & Co.
as at 31.12. 2013

Liabilities		₹	*Assets*		₹
Sundry creditors		30,000	Cash in Bank		25,000
Loan		10,000	Bill Receivables		8,000
Interest outstanding		600	Sundry Debtors	45,000	
Outstanding Expenses :			*Less :* Reserve for		
Wages	1,000		Doubtful Debts	2,250	42,750
Rent	500	1,500	Closing Stock		30,000

Capital	1,50,000		Furniture & Fixture	4,000	
Add : Net Profit	16,250	1,66,250	*Less :* Dep.	400	3,600
			Plant & Machinery	40,000	
			Less : Dep.	2,000	38,000
			Land & Building		60,000
			Commission Accrued		1,000
		2,08,350			2,08,350

Illustration : 5

From the following balances of the year ending 31st December, 2013 and additional information prepare the Trading and Profit and Loss Account and the Balance Sheet of M/s Kanohal and Sons.

	₹		₹
Capital	80,000	Insurance	600
Purchases	82,000	Salaries	12,500
Sales	1,10,000	Bad Debts	200
Return Outwards	1,000	Carriage on Purchase	200
Buildings	45,000	Commission (Cr.)	1,500
Opening Stock	15,000	Cash in Hand	5,000
Debtors	20,100	Cash at Bank	25,000
Creditors	28,000	Sales Tax Paid	5,000
Furniture	7,000	Sales Tax Collected	3,500
Wages	1,800	Interest on Investments	500
Rent	5,100		

Additional Information:

(a) Closing Stock was valued at ₹ 20,000.

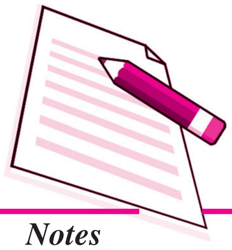
(b) Provide Depreciation on building @5% and on furniture @10%.

(c) Outstanding salaries ₹ 1,000.

(d) Unexpired insurance ₹ 50.

(e) Accrued commission ₹ 300

(f) Provide for Manager's Commission at 5% on net profit after charging such commision.



Notes

Solution :

Trading and Profit & Loss Account
for the ended 31st December, 2013

Dr. Cr.

Particulars		₹	*Particulars*		₹
To Opening Stock		15,000	By Sales		1,10,000
To Purchases	82,000		By Closing Stock		20,000
Less : Return Outward	1,000	81,000			
To Wages		1,800			
To Carriage on Purchases		200			
To Gross Profit c/d		32,000			
		1,30,000			1,30,000
To Rent		5,100	By Gross Profit b/d		32,000
To Insurance	600		By Interest on Investment		500
Less : Unexpired Insurance	50	550	By Commission	1,500	
To Salaries	12,500		Add : Accrued		
Add : Outstanding			Commission	300	1,800
Salaries	1,000	13,500			
To Bad Debts		200			
To Depreciation on :					
Building	2,250				
Furniture	700	2,950			
To Net Profit before					
Manager's Commission		12,000			
		34,300			34,300
To Manager's Commission			By Net Profit before		
(5/105 x 12,000)		571	Manager's Commission		12,000
To Net Profit after Manager					
Commission		11,429			
		12,000			12,000

Balance Sheet
as at 31st December, 2013

Liabilities	₹	**Assets**	₹
Creditors	28,000	Cash in Hand	5,000
Outstanding Salary	1,000	Cash at Bank	25,000
Manager's Commission	571	Closing Stock	20,000

Capital	80,000		Debtors		20,100
Add : Net Profit	11,429	91,429	Advance Sales Tax Paid		
			(Sales Tax Paid - Sales Tax Collected)		1,500
			Accrued Commission		300
			Prepaid Insurance		50
			Building	45,000	
			Less : Depreciation	2,250	42,750
			Furniture	7,000	
			Less : Depreciation	700	6,300
		1,21,000			1,21,000

Notes

13. Abnormal Losses

Such losses occur because of fire, earthquakes or accidents. These may destroy some fixed assets of the firm. In such case an Asset Account is credited and the Profit and Loss Account is debited. The debit may be spread over two or three years.

Stock of goods may also be destroyed or damaged by fire, or other causes. It is obvious that because of this, the value of the stock will be lower than otherwise. This will reduce the amount of gross and net profit. It is, however, better to ascertain the gross profit which would have been earned without the loss since this enables the firm to judge its trading operations properly. To nullify the effect of loss of stock, the Trading Account is credited with the cost of the goods destroyed. If the goods destroyed are not insured then the cost price of the goods destroyed is debited to Profit and Loss Account. If the goods are insured, then the claim admitted by the insurance company is deducted and the claim not admitted is debited to the Profit and Loss Account. The adjusting entries are as follows :

(i) Accidental Loss of Stock A/c
or Loss by Fire ...Dr. [Total Value of Abnormal Loss]
To Trading A/c

(ii) Insurance Claim or Insurance Co. ...Dr. [Amount of Insurance Claim]
Profit and Loss A/c ...Dr. [Value of Irrecovered Loss]
To Accidental Loss of Stock A/c [Total Value of Abnormal Loss]

Insurance Company's Account will be shown as an asset in Balance Sheet

Note : If stock is not insured, following entry will be passed.

Profit and Loss A/c ...Dr. [Total Value of Abnormal Loss]
To Trading A/c

Illustration : 6

On 31st Dec. 2013, stocks worth ₹ 4,00,000 were destroyed by fire. The stock was insured and the insurance company admitted the claim of ₹ 3,00,000 only. Give the necessary journal entries and show how it will be treated in the Final Accounts.

Solution :

Journal

Date	*Particulars*		*LF.*	*Dr. (₹)*	*Cr. (₹)*
2013					
Dec. 31	Loss by Fire A/c	Dr.		4,00,000	
	To Trading A/c				4,00,000
	(Being loss of stock by fire)				
Mar. 31	Insurance Co.	Dr.		3,00,000	
	P & L A/c	Dr.		1,00,000	
	To Loss by fire A/c				4,00,000
	(Being insurance co. admitted a partial claim only)				

Trading Account
for the year ended 31st Dec. 2013

Dr. Cr.

Particulars	₹	*Particulars*	₹
		By Loss by Fire A/c	4,00,000

Profit and Loss Account
for the year ended 31st Dec. 2013

Dr. Cr.

Particulars		₹	*Particulars*	₹
To Loss by fire	4,00,000			
Less : Ins. Claim	3,00,000	1,00,000		

Balance Sheet
as at 31st Dec. 2013

Liabilities	₹	*Asset*	₹
		Current Assets	
		Claim due from Insurance Co.	3,00,000

Illustration : 7

From the following Ledger balances of Mr. Ghanshyam, prepare the Trading and Profit and Loss Account for the year ended 31st March 2013 and the Balance Sheet as on that date after making the necessary adjustments.

Particulars	₹	*Particulars*	₹
Trade Expenses	8,000	Purchases	8,20,000
Freight and Duty	20,000	Stock on (1.4.2012)	1,50,000
Carriage Outwards	5,000	Plant and Machinery (1.4.2012)	2,00,000
Sundry Debtors	2,06,000	Pland and Machinery (additions	
Furniture and Fixtures	50,000	on 1.10.2012)	50,000
Return Inwards	20,000	Drawings	60,000
Printing and Stationery	4,000	Capital	8,00,000
Rent, Rates and Taxes	46,000	Reserve for Doubtful Debts	8,000
Sundry Creditors	1,00,000	Rent for Premises Sublet	16,000
Sales	12,00,000	Insurance Charges	7,000
Return Outwards	10,000	Salaries and wages	2,13,000
Postage and Telegraphs	8,000	Cash in Hand	62,000
		Cash at Bank	2,05,000

Adjustments :

(i) Stock on 31st March 2013 was ₹ 1,40,000.

(ii) Write off ₹ 6,000 as Bad Debts.

(iii) Provision for Doubtful Debts is to be maintained @5%.

(iv) Provide Depreciation on furniture and fixtures at 5% p.a. and on plant and machinery at 20% p.a.

(v) Insurance prepaid was ₹ 1,000.

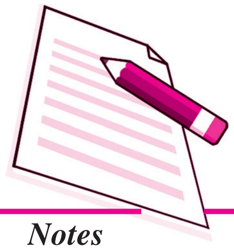
(vi) A fire occurred in the godown and stock of the value of ₹ 50,000 was destroyed. It was insured and the insurance company admitted full claim.

Solution :

Trading and Profit and Loss Account
for the year ended 31st March, 2013

Dr. Cr.

Particulars		₹	*Particulars*		₹
To Opening Stock		1,50,000	By Sales	12,00,000	
To Purchases	8,20,000		**Less :** Return Inwards	20,000	11,80,000
Less : Return Outwards	10,000	8,10,000	By Loss of Stock by Fire A/c		50,000
To Freight and Duty		20,000	By Closing Stock		1,40,000
To Gross Profit c/d		3,90,000			
		13,70,000			13,70,000



Notes

To Trade Expenses		8,000	By Gross Profit b/d	3,90,000
To Carriage Outwards		5,000	By Rent for Premises	16,000
To Depreciation on Furniture				
and Fixtures		2,500		
To Dep. on Plant and Machinery				
2,00,000 x 20/100	40,000			
5,000 x 20/100 x 6/12	5,000	45,000		
To Printing & Stationery		4,000		
To Rent, Rates and Taxes		46,000		
To Insurance	7,000			
Less : Prepaid	1,000	6,000		
To Salaries and Wages		2,13,000		
To Postage and Telegraphs		8,000		
To Provision for Doubtful				
Debts (Closing)				
(₹ 2,00,000 x 5/100)	10,000			
Add : Bad Debts	6,000			
	16,000			
Less: Provison for Doubtful				
Debts (Opening)	8,000	8,000		
To Net Profit transferred				
to Capital A/c		60,500		
		4,06,000		4,06,000

Balance Sheet
as at 31st March, 2013

Libilities		₹	*Assets*		₹
Current Liabilities			**Current Assets**		
Sundry Creditors		1,00,000	Cash in Hand		62,000
Capital			Cash at Bank		2,05,000
Opening Balance	8,00,000		Sundry Debtors	2,06,000	
Add: Net Profit	60,500		*Less:* Further Bad Debts	6,000	
	8,60,500			2,00,000	
Less: Drawings	60,000	8,00,500	*Less:* Provision for		
			Doubtful Debts	10,000	1,90,000
			Closing Stock		1,40,000
			Insurance Claim		50,000
			Prepaid Insurance		1,000
			Fixed Assets		
			Furniture and Fixture	50,000	
			Less: Depreciation	2,500	47,500

		Plant and Machinery	2,50,000	
		Less: Depreciation	45,000	2,05,000
	9,00,500			9,00,500

14. Drawings of Goods by the Proprietor

When the proprietor draws some goods or cash from the business for his/her personal use, it is a drawing.

Now, if you find that this has not been recorded in the books, you have to make the necessary adjustments to take it into the Final Accounts. Then the treatment of such drawings of goods by the proprietor in the Final Account is as follows:

i. Deduct it from purchases on the debit side of Trading A/c.

ii. Deduct it either from the capital or add to drawings on the liability side of the Balance Sheet.

Accounting Treatment of Drawings

I. Drawing made in cash

(i) Drawings A/c Dr.

To Cash/Bank A/c

(Being cash withdrawn for personal use)

(ii) Capital A/c Dr.

To Drawings A/c

(Being drawings transferred)

II. Withdrawal of Goods by the Proprietor

(i) Drawings A/c Dr.

To Purchases A/c

(Being goods withdrawn for personal use)

(ii) Capital A/c Dr.

To Drawings A/c

(Being drawings transferred)

III. Income Tax Paid by sole proprietor out of the entity's (business) cash

(i) Income Tax A/c Dr.

To Cash/Bank A/c

(Being Income Tax Paid)

Notes

Notes

(ii) Drawings A/c Dr.

To Income Tax

(Being Income Tax Transferred)

(iii) Capital A/c Dr.

To Drawings

(Being drawings transferred)

15. *Goods Distributed as Free Samples*

For sales promotion, some of the goods may be distributed as free samples. For example, if goods worth ₹ 10,000 are distributed as free samples then it will be an advertisement for the concern but on the other hand the stocks will be less by goods of such value. In order to bring this into the books of accounts the following entry is passed :

Advertisement A/c Dr.

To Purchases A/c

(Being goods distributed as free samples)

The two-hold effect of this entry will be :

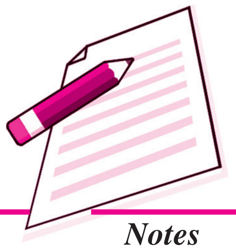
i. It is shown on the credit side of Trading A/c, or deducted from the purchases.

ii. It is shown on the debit side of the profit and loss A/c as advertisement expenses.

Illustration : 8

From the following Trail Balance, Prepare the Trading and Profit & Loss A/c for the year ended March 31, 2014 and the balance sheet as on that date :

Debit Balance	₹	*Credit Balance*	₹
Salaries	10,600	Sales	66,420
Bills Receivable	6,000	Capital	50,000
Investments	40,000	Pro. for Doubtful Debts.	2,500
Furniture	12,000	10% Loan (1.10.2013)	10,000
Opening Stock	4,500	Discount Received	400
Purchases	30,000	Sundry Creditors	9,300
Sundry Debtors	20,000	Bills Payable	5,000
Interest on Loan	400	Outstanding Salaries	500
Insurance Premium	900	Bad Debts Recovered	200
Wages	4,600	Interest on Investments	2,000



Notes

Rent	1,520	Trading Commission	7,000
Bad Debts	1,200		
Carriage Outwards	600		
Cash at Bank	10,000		
Depreciation on Furniture	2,500		
Accrued Commission	1,000		
Advertisement	7,500		
	1,53,320		1,53,320

Adjustments :

i. Closing Stock - ₹ 6,000.

ii. Goods costing ₹ 1,000 were distributed as free samples while goods costing ₹ 500 were taken by the proprietor for personal use.

iii. A credit sale of ₹ 2,000 was not recorded in the sales book.

iv. Closing Stock included goods costing ₹ 1,000 which were sold and recorded as sales but not delivered to the customer.

v. Maintain provision for Doubtful Debts @5%.

vi. Only one-third advertising expenses are to be written off.

Solution

Trading and Profit & Loss Account
for the year ending 31st March, 2014

Dr. Cr.

Particulars		₹	*Particulars*		₹
To Opening Stock		4,500	By Sales	66,420	
To Purchases	30,000		*Add :* Credit Sales	2,000	68,420
Less: Free Samples	1,000		By Closing Stock	6,000	
	29,000		*Less:* Cost of Goods sold		
Less : Drawing of Goods	500	28,500	but not delivered	1,000	5,000
To Wages		4,600			
To Gross Profit c/d		35,820			
		73,420			73,420
To Salaries		10,600	By Gross Profit b/d		35,820
To Interest on Loan	400		By Old Pro. for Bad Debts	2,500	
Add: Outstanding Interest			*Less:* Bad Debts	1,200	
on Loan	100	500		1,300	
To Insurance Premium		900	*Less :* New Provision	1,100	200

To Rent	1,520	By Discount Received	400
To Carriage Outwards	600	By Bad Debts Recovered	200
To Depreciation of Furniture	2,500	By Interest on Investment	2,000
To Advertisement	2,500	By Trading Commission	7,000
To Free Samples	1,000		
To Net Profit transferred to Capital A/c	25,500		
	45,620		45,620

Balance Sheet
as at 31st March, 2013

Liabilities		₹	*Assets*		₹
Capital	50,000		Bill Receivable		6,000
Add: Net Profit	25,500		Investments		40,000
	75,500		Furniture		12,000
Less: Drawings	500	75,000	Debtors	20,000	
10% Loan		10,000	*Add:* Credit Sales Not		
Outstanding Interest on Loan		100	Recorded	2,000	
Creditors		9,300		22,000	
Bills Payable		5,000	*Less:* New Provision	1,100	20,900
Outstanding Salaries		500	Accrued Commission		1,000
			Closing Stock		5,000
			Bank		10,000
			Unexpired Advertisement Exp.		5,000
		99,900			99,900

Summarised view of Adjustment Entries

Adjustment	*Adjustment entry*	*Treatment in Trading and Profit & Loss A/c*	*Treatment in Balance Sheet*
1. Closing stock	Closing stock A/c Dr To Trading A/c	Shown on the credit side of Trading A/c	Shown on the Assets side
2. Outstanding expenses	Expenses A/c Dr To Outstanding expenses A/c	Added to respective expenses on the debit side	Shown on the liabilities side
3. Prepaid expenses	Prepaid expenses A/c Dr To Expenses A/c	Deducted from the respective expenses on the debit side	Shown on the Assets side
4. Accrued income	Accrued income A/c Dr To Income A/c	Added to the respective income on the credit side	Shown on the Assets side

Notes

5. Income received in advance	Income A/c Dr To income received in advance A/c	Deducted from the respective income on the credit side	Shownn on the liabilities side
6. Interest on capital	Interest on capital A/c Dr To capital A/c	Shown on the debit side of P&L A/c	Shown as addition to capital on liabilities side
7. Interest on drawings	Capital A/c Dr To interest on drawing A/c	Shown on the credit side P&L A/c	Shown as deduction to capital on liabilities side
8. Depreciation	Depreciation A/c Dr To Assets A/c	Shown on the debit side P&L A/c	Deducted from the value of Assets
9. Further bad debts	Bad Debts A/c Dr To Debtors A/c	Shown on the debit side P&L A/c	Deducted from debtors, shown on Assets side
10. Provision for bad and doubtful debts	Profit & Loss A/c Dr To Provision for bad and doubtful debts	Shown on the debit side P&L A/c	Shown as deduction from debtors on Assets side.
11. Provision for Discount on Debtors	Profit & Loss A/c Dr. To Provision for Discount	Shown on the debit side P&L A/c	Shown as deduction from debtors on Assets side.
12. Commission to Manager	Profit & Loss A/c Dr. To Manager's Commission	Shown on the debit side P&L A/c	Shown in liability side
13. Extra Ordinary Loss	Profit & Loss A/c Dr. To Extra Ordinary Loss	Shown on the debit side P&L A/c	Shown as deduction from concerned Asset on Assets side.
14. Drawings of goods by the Owner	Drawings A/c Dr. To Purchases A/c	To be deducted from purchases.	Shown as deduction from Capital on Liabilities side.
15. Distribution of goods as free samples	Advertisement A/c Dr. To Purchases A/c	To be deducted from purchases.	Shown on debit side of P & L A/c

Notes

INTEXT QUESTIONS 18.4

State whether the following statements are True or False :

i. Proprietor draws some goods or cash from the business is a drawing.

ii. If proprietor draws goods then it will be deducted from purchases.

iii. Drawing is an asset.

iv. Good distributed as free samples is advertisement for the business.

v. Goods distributed as free sample is shown on the debit side of trading A/c.

WHAT YOU HAVE LEARNT

- Adjustments are needed to be accounted for so that Income Statement and Position Statement show the correct profit or loss and financial position.
- There can be items of income and expenditure which do not pertain to the accounting year for which financial statements are being prepared. These are to be excluded. These are called prepaid items.
- There can be items of expenses and income which are left out and are to be accounted, which are called outstanding expenses or accrued incomes.
- Other important adjustments to be carried out are Closing Stock, Depreciation on fixed assets, interest on capital and interest on Drawings.
- There may be further bad debts and provision for bad and doubtful debts need to be made on debtors.
- Further bad debts are irrecoverable debts in addition to what has been shown in the Trial Balance as bad debts
- Provision for bad and doubtful debts is created for future payments due from debtors but seems to be irrecoverable. It is created on the basis of past experiences.
- The Process of creating provision for discount on debtors is same as provision for doubtful debts. The likely amount of the discount to be allowed is debited to the P&L A/c and the same will be deducted from debtors in the balance sheet.
- If the manager is allowed commission on the net profit before charging such commission then the following formula should be used :

$$\text{Net Profit} \times \frac{\%\text{ of commission}}{100}$$

and if the manager is entitled for commission. On the net profit after charging such commission then the following formula should be used :

$$\text{Net Profit} \times \frac{\%\text{ of commission}}{(100 + \%\text{ of commission})}$$

- Abnormal losses occur because of fire, earthquakes or accidents. These may destroy some fixed assets of the firm. In such case an Asset Account is credited to trading A/c and debited to profit and loss A/c debited.
- Drawings of goods by the propriter is deducted from purchases on the debit side of Trading A/c., and deducted from capital in Balance Shet.
- Goods distributed as free sample is duducted from purchases and shown in the debit side of P&L A/c as advertisement.

Notes

TERMINAL EXERCISE

1. Answer the following questions in brief.
   (a) Why are adjustments needed?
   (b) Why are outstanding expenses treated as liabilities?
   (c) What is the difference between accrued income and unearned income?
2. Pass necessary journal entries for following adjustments :
   i. Wages outstanding
   ii. Depreciation on Furniture
   iii. Interest on Investment accrued but not received
   iv. Insurance Premium paid in advance
3. Why reserve is created for doubtful debts?
4. From the following trial balance of M/s V.B. Fertilizers prepare Trading & Profit and Loss Account for the year ending 31st December, 2013 and Balance Sheet as on that date. Also pass Journal entries for the adjustments:

Particulars	*Dr. (₹)*	*Particulars*	*Cr (₹)*
Stock (1.1.2013)	13,800	Capital	65,000
Purchases	52,000	Bills payable	18,000
Wages	4,000	Sales	74,400
Return inward	2,400	Return outward	1,500
Land & Building	40,000	Discount	450
Plant & machinery	24,500	Creditors	6,500
Bills receivable	12,000	Interest	600
Debtors	5,500	Bad debts Reserve	250

Notes

Cash in hand & at Bank	8,750	Loan	8,000
Rent (office)	2,200	Commission	700
Bad Debts	400		
Insurance	1,500		
Freight inward	1,400		
Fuel & Power	2,450		
Furniture	4,500		
	1,75,400		1,75,400

Adjustments

i. Stock on 31.12.2013 ₹ 25,000.

ii. Write off depreciation on furniture 10% and on plant & machinery 20%.

iii. Provide for wages outstanding ₹650 and rent outstanding ₹ 200. Prepaid insurance amounted to ₹ 300.

iv. Further bad debts amounted to ₹ 100. Make a provision for bad & doubtful debts @ 5% on debtors.

v. Interest on capital to be allowed @ 6%.

5. On 1st April, 2013 reserve for Bad Debts shows a balance of ₹ 3,200 Bad debts during the year as per ledger were ₹ 2,100. Debtors amounted to ₹7,000. After closing of the ledger, it was found that there were bad debts of ₹ 800. It was decided to create a reserve for doubtful debts on creditors @6%.

   Pass necessary journal entries and show the items in Profit & Loss account and Balance Sheet.

6. From the following trial balance of Pranaya as at 31st December, 2014, prepare Trading and Profit & loss account for the year ended 31st December, 2014 and a Balance Sheet as on that date after making necessary adjustments. Also Give journal entries for these adjustments

Trial Balance
as at 31-12-2014

Name of Account	*Dr. Balances (₹)*	*Dr. Balances (₹)*
Pranaya's Capital Account		1,00,000
Drawings	24,000	–
Plant and Machinery	45,000	–
Stock (1st Jan, 2014)	15,000	–
Purchases	85,000	–
Return inwards	5,000	–
Sundry Debtors	24,600	–

Notes

Freight and duty	2,000	–
Carriage outwards	1,600	–
Rent Rates & Taxes	3,800	–
Sundry Creditors	–	22,000
Postage & Courier Expenses	1,800	
Sales	–	1,35,000
Provision for Bad Debts	–	600
Discount	–	800
Insurance Premium	900	–
Wages	23,000	–
Cash in Hand	6,200	–
Cash at Bank	20,500	–
	2,58,400	2,58,400

Adjustments

i. Stock on 31st December, 2014 was valued at ₹ 24,000.

ii. Write off ₹ 600 as bad debts.

iii. Provision for doubtful debts is to be maintained at 5% on sundry debtors.

iv. Provide depreciation on plant and machinery at 20%. A machine costing ₹ 1,500 was purchased on 1st July, 2014.

v. Wages outstanding amounted to ₹ 1,500, and Insurance Prepaid was ₹ 250.

7. The following are the balances extracted from the books of Chinmay Aggarwal on 31st March 2014.

	₹		₹
Chinmay's Capital	60,000	Stock (1.4.2013)	44,200
Furniture & Fixtures	5,000	Debtors	36,000
Bank Overdraft	8,400	Rent received	2,000
Creditors	27,600	Purchases	2,20,000
Business Premises	50,000	Sales	3,00,000
Discount (Dr)	3,200	Sales Returns	4,000
Tax & Insurance	4,000	Bills Payable	10,000
Salaries	20,000		
Commission (Cr.)	2,000		
Carriage inward	3,600		
Bad Debts	1,600		
Motor Vehicle	14,400		
Investments	4,000		

Following adjustments are to be made :

(i) Stock on 31 March, 2014 ₹ 35,000.

Notes

(ii) Write off depreciation on :

Business Premises ₹ 800

Furniture & Fixture ₹ 500

Motor Vehicle 10% p.a.

(iii) Interest on bank overdraft ₹ 150.

(iv) Interest on capital was to be allowed @ 6% p.a.

(v) Make a provision of 5% on debtors for doubtful debts.

(vi) Carry forward ₹ 500 for unexpired insurance.

Prepare Trading and Profit & loss A/c for the year ended 31st March, 2014 and Balance Sheet as on that date.

8. Pass necessary journal entries for the following adjustments :

   i. 1/3rd of the total commission received during the year of ₹12000 relates to the next year

   ii. Insurance premium of Rs.8000 is paid for the year ending 30st June. Accounts are closed on 31st March every year.

   iii. Interest on drawing is charged for the year amounting to ₹ 450.

9. Explain the following adjustments with examples :

   i. Provision for discount on debtors.

   ii. Manager's Commission

10. What do you mean by Abnormal loss? Also explain its accounting treatment with the help of an example.

11. Explain the accounting treatment of drawing of goods by the proprietor and goods distributed as free samples.

ANSWERS TO INTEXT QUESTIONS

18.1 (i) profit, loss (ii) profit or loss, financial position

(iii) excluded (iv) accounted for

18.2 (i) Outstanding expenses (ii) Prepaid expenses

(iii) Accrued income (iv) Income received in advance

18.3 I. (i) provision for bad & doubtful debts

(ii) depreciation (iii) bad debts (iv) closing stock

II. (i) To capital account (ii) To wages outstanding A/c

(iii) To insurance premium A/c

(iv) To commission received in advance A/c

III. (i) False (ii) True (iii) False (iv) False (v) True

IV. (i) Debit (ii) Liability

18.4 (i) True (ii) True (iii) False (iv) True (v) False

Notes

ANSWERS TO TERMINAL EXERCISE

4. (G.P. ₹ 24200; N.P. ₹ 12580

   Total of Balance Sheet ₹ 114830

6. G.P. ₹ 27500; N.P. ₹ 10400

   Total Balance Sheet ₹ 109900

7. G.P. ₹ 63200; N.P. ₹ 30610

   Total balance Sheet : ₹ 140360

ACTIVITY

Analyse the financial statements of at least four business concerns and record the rate at which depreciaiton is charged on various fixed assets and provision is made for doubtful debts and find out the reasons of variation.

S.No.	*Name of Business concern*	*Rate of Depreciation*	*Reasons of variation*

320en19

19

NOT FOR PROFIT ORGANISATION - AN INTRODUCTION

You buy goods of daily consumption from the general store of your locality, such as clothes from cloth shop or you see a movie in a cinema hall. These are all business organisations that deal in purchasing and selling goods and services. Their objective is to earn profit. You must have studied in a school, you go to a hospital for treatment. You may be a member of a sports club of your area. These are the organisations that are founded not to earn profits but to provide services to their members and to the public in general. You have learnt the preparation of financial statements of profit organisations. While performing the activities, these organisations also engage in financial transactions. They also want to know the results of their activities for a particular period. For this they also prepare financial statements. You will now study in this lesson the system of accounting of these organisations i.e. Not for Profit Organisations (NPOs) such as sports club literary society, etc.

OBJECTIVES

After studying this lesson, you will be able to :

- state the meaning and characteristics of Not-for-Profit Organisations;
- state the meaning and need for preparing Receipts and Payments account;
- identify the items of Receipts and Payments Account and prepare Receipts and Payments Account as per format; and
- distinguish between Receipts and Payments Account and Cash Book.

19.1 NOT-FOR-PROFIT ORGANISATIONS–MEANING AND CHARACTERISTICS

You must have come across organisations which are not engaged in business activities. Their objective is not to make profits but to provide service. Examples of such organisations are : schools, hospitals, charitable institutions, welfare societies, clubs, public libraries, resident welfare association, sports club etc. These are called Not-for-Profit Organisations (NPOs). These organisations provide services to their members and to the public in general. Their main source of income is membership fees, subscription, donation, grant-in-aid, etc. As the money is involved in the activities of these organisations, they also maintain accounts. These organisations prepare certain statements to ascertain the results in financial terms of their activities for a particular period say, one year.

Characteristics of Not-for-profit organisations (NPOs)

Following are the main characteristics or the salient features of Not for Profit organisations (NPOs) :

1. The objective of such organisations is not to make profit but to provide service to its members and to the society in general.
2. The main source of income of these organisations is not the profit earned from purchase and sale of goods and services but is admissions fees, subscriptions, donations, grant-in-aid, etc.
3. These organisations are managed by a group of persons elected by the members from among themselves. This group is called managing committee.
4. They also prepare their accounts following the same accounting principles and systems that are followed by business for profit organisations that are run with an objective to earn profits :

Financial statements that are generally prepared by Not-for-Profit Organisations (NPOs) are :

1. Receipts and Payments Account
2. Income and Expenditure Account
3. Balance Sheet

Notes

The receipts and payments account is the summary of cash and bank transactions which helps in the preparation of Income and expenditure Account and the Balance Sheet.

Income and Expenditure A/c is similar to Profit and Loss Account. NPOs usually prepares the Income and Expenditure Account and Balance Sheet with the help of Receipts and Payments Account.

INTEXT QUESTIONS 19.1

Following are the statements about Not-for-Profit organisation. Put (√) mark against the statements which are the salient features of these organisations and (X) against the others :

(i) The main objective of these organisations is to make profits.

(ii) These organisations provide service to the society.

(iii) The accounting principles and system followed by such organisations are the same that are followed by business organisations i.e. meant to earn profit.

19.2 RECEIPTS AND PAYMENTS ACCOUNT–MEANING AND NEED

Like any other organisation, Not-for-Profit Organizations (NPOs) also maintain cash book to record cash transactions on day to day basis. But at the end of the year they prepare a summary of cash transactions based on the cash-book. This summary is prepared in the form of an account. It is called Receipts and Payments account. All cash receipts and payments are recorded in this account whether these belong to current year or next year or previous year. All receipts and payments are recorded in this account whether these are of revenue nature or capital nature. As it is an account so it has the debit side and the credit side. All receipts are recorded on its debit side while all payments are shown on the credit side. This account begins with opening cash or/and bank balance. Closing balance of this account is cash in hand and or cash at bank/overdraft. Items in this account are recorded under suitable heads.

Following are the main features of Receipts and Payments Account :

1. It is prepared at the end of the year taking items from the cash book.
2. It is the summary of all cash transactions of a year put under various heads.

3. It records all cash transactions which occured during the year concerned irrespective of the period they relate to i.e. previous/current/next year.
4. It records cash transactions both of revenue nature and capital nature.
5. It begins with opening balance and ends with closing balance.

Need for preparing Receipts and Payments Account

As most of the transactions of Not-for-Profit Organisations are for cash, the Receipts and Payments Account shows most of the items at one place.

As it is in a summary form, it gives an idea of large number of transactions at a glance. It contains accounting information under various heads. So it gives information itemwise for the accounting year.

It shows the closing cash or/and bank balance, this cash/Bank balance is taken to the Balance Sheet.

The Receipts and Payments Account serves the purpose of trial balance and becomes the basis of preparing financial statements i.e. Income and Expenditure Account and Balance Sheet for the organisation.

Very small Not-for-Profit Organisations (NPOs) prepare only Receipts and Payments Account.

As the name itself suggests, Receipts and Payments Account is an account which has two sides, the debit side and the credit side. All cash receipts are shown on the debit side and all cash payments on the credit side. It has a definite format which is given below :

FORMAT OF RECEIPTS AND PAYMENTS ACCOUNT

Receipts and Payments Account of ....

For the year ended on ....

Dr. Cr

Receipts	*Amount* ₹	*Payments* ₹	*Amount*
Balance b/d :		Purchase of Assets	
Cash		Printing and stationery	
Bank		Repairs and Renewal	

Notes

Donations		Newspapers/Magazines	
Legacies		Rent and taxes	
Membership fees		Postage	
Entrance fees		Investments	
Subscriptions		Conveyance	
Donations		Honorarium	
Lockers Rent		Charity	
Sale of fixed assets		Insurance Premium	
Interest on investments		Upkeep of Ground	
Miscellaneous Receipts		Telephone Charges	
Sale of old periodicals		Balance c/d :	
		Cash	
		Bank	

INTEXT QUESTIONS 19.2

I. Following are the items of Not for Profit organisations. Classify them into Receipts and Payments.

(i) Donations (ii) Charity (iii) Subscription

(iv) Purchase of Books (v) Legacies (vi) Honorarium

II. Identify the following statements as characteristics or need of Receipts and Payments account

(i) Closing cash or/and Bank Balance is used to prepare Balance Sheet.

(ii) It is prepared from the items taken from cash book.

(iii) It records cash transactions both of revenue nature and capital nature.

(iv) It is used to prepare financial statements of the Not for Profit organisations.

Notes

19.3 SPECIFIC ITEMS OF RECEIPTS AND PAYMENTS ACCOUNT

1. **Subscription :** It is a regular payment made by the members to the organisation. It is generally contributed annually. It is one of the main sources of income. Subscriptions received during the year are shown on the debit side i.e. Receipts side of the Receipts and Payments Account. Apart from amount for current year, it may include amount pertaining to previous year or advance payment for next years.

2. **Entrance fees or Admission fees :** Whenever a person is admitted as a member of the organisation, certain amount is charged from him/her to give him/her admission. This is called entrance fee or admission fee. Total amount of enterance fee received during a year is shown on the debit side of the Receipts and Payments Account.

3. **Life membership fees :** Membership, if granted to a person for the whole life, special fee is charged from him/her, this is called life membership fees. It is charged once in the life time of a member. It is a capital receipt for the organisation.

4. **Endowment fund :** It is a fund which provides permanent means of support for the organisation. Any contribution towards this fund is an item of capital receipt.

5. **Donation :** Donation is the amount received from some person, firm, company or any other body by way of gift. It is also an important item of receipt. It can be of two types :

   (a) **Specific donation :** It is a donation received for a specific purpose. Examples of such donations are : donation for library, donation for building, etc.

   (b) **General donation :** It is a donation which is received not for some specific purpose. It can be of two types :

      (i) General donation of big amount

      (ii) General donation of small amount

6. **Legacy :** It is the amount which is received by organisations as per the will of a deceased person. It is treated as a capital receipt.

7. **Sale of old newspapers/periodicals and sports material :** Old newspapers, used/condemned sports material are sold and may fetch some money. It is a source of revenue. Money realised from the sale of such items is shown on the debit (Receipts) side of Receipt and Payment Account.

8. **Purchase of fixed assets :** Assets such as building, machinery, furniture, books etc. are purchased for the organisation. These are items of capital expenditure. Payment made for the purchase of such assets is shown on the credit side i.e. the payment side of Receipts and Payments Account.

9. **Payment of honorarium :** This is another item of payment. This is an amount paid to persons who are not the employees of the organisation but take part in the activities of the organisation. Remuneration paid to them is called honorarium. For example, payment made to the secretary of the club as honorarium. This is a payment of revenue nature.

10. **Purchase of consumable items :** Items such as stationery, sports material, drugs and medicines etc. are called consumable items. Payments are regularly made by Not-for-Profit Organisation (NPO for the use of such items). These are shown on the payment side of Receipt & Payment Account.

Such payments may also be made for rent, salary, insurance, office expenses etc. which are payments made as revenue expenditure by both businesses for profit and not for Profit Organisations (NPOs).

Preparation of Receipts and Payments Account

Following are the steps followed to prepare Receipts and Payments A/c :

- At first, the cash and bank balance carried forward from the last year is shown on its debit side. In case there is bank overdraft at the beginning of the year, enter the same on the credit side of this account.
- The amounts are shown under relevant heads such as subscription, donations etc. on the receipts side and salary, rent, purchase of sports equipment, books etc. on the Payment side.
- The amounts comprise of only cash and all cash received or paid during the period for which Receipts and Payments Account is prepared. No distinction is made between the items of revenue nature or capital nature and whether these belong to current year, previous year or the coming year.

Finally, this account is balanced by deducting the total of the credit side i.e. the total payments from the total of the debit side i.e. total receipts and is put on the credit side as 'balance c/d'.

It shows the closing cash and Bank balance which is shown on the asset side of the Balance sheet of the concerned organisation.

INTEXT QUESTIONS 19.3

A student has prepared the following Receipts and Payments A/c. Some of the items have been entered on wrong side. Correct the Account.

Receipts and Payments A/c
for the year ended 31st Dec. 2013

Dr Cr

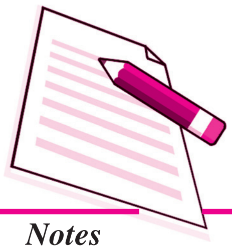
Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Opening balance	1,800	Entrance fees	400
Wages	800	Sale of Newspapers	200
Subscription	3,600	Purchase of Books	2,400
		Cash in hand	2,300
		Telephone charges	600
		Interest on Fixed deposit	300
	6,200		6,200

19.4 RECEIPTS AND PAYMENTS ACCOUNT AND CASH BOOK

You have learnt about Cash Book and Receipts and Payments Account. You have also learnt that Receipts and Payments Account is prepared with the items taken from the cash Book, still there are some differences between the two which are given as below:

Difference between Receipts and Payments Account and Cash Book

Receipts and Payment Account	*Cash Book*
1. It is prepared at the end of the accounting year.	It is prepared on day-to-day basis.
2. An item appears only once.	Items appear number of times on different dates depending upon their occurence.



Notes

3. It serves the purpose of Trial Balance to prepare the financial statements.	It is a means of maintaining record of cash transactions.
4. It reflects the activities of the organisaiton.	It is only a systematic record of day to day cash transactions.
5. It is prepared only by Not-for-Profit Organisations (NPOs).	It is also prepared by business organisations meant to earn profit.

Illustration 1

From the information given below prepare Receipts and Payments Account for the year ending 31st December, 2013.

	₹		₹
Opening Balance :			
Cash in hand	1,650	Purchase of Books	10,000
Cash at Bank	18,250	Purchase of Sports Material	20,000
Subscription	15,000	Purchase of Bicycle	2,000
Entrance Fees	1,200	Sale of Investment	25,000
Donation	18,000	Life Membership Fees	4,000
Salaries	16,000	Rent paid	12,000
Stationery	500	Purchase of Government Bonds	10,000
Insurance Premium	800	***Closing Balance :***	
Sale of old Furniture	1,540	Cash in hand	1,510
Interest on Securities	3,670	Cash at Bank	20,000
Lockers Rent	4,500		

Solution :

Receipts & Payments A/c

for the year ending 31st Dec. 2013

Receipts	*Amount (₹)*	*Payments*	*Amount (₹)*
Balance b/d			
Cash in hand	1,650	Salaries	16,000
Cash at Bank	18,250	Stationery	500

Notes

Entrance Fees	1,200	Insurance Premium	800
Donation	18,000	Purchase of Books	10,000
Sale of old furnitrue	1,540	Purchase of Sports Material	20,000
Interest on securities	3,670	Purchase of Bicycle	2,000
Lockers Rent	4,500	Rent paid	12,000
Sale of Investment	25,000	Purchase of Government bonds	10,000
Subscription	15,000	Balance c/d	
Life Membership fees	4,000	Cash in hand	1,510
		Cash at bank	20,000
	92,810		92,810

Illustration 2

From the information given below prepare Receipts and Payments Account of Rising Sun Club for the year ended on March 31, 2014.

Details		***Amounts (₹)***
Cash in hand as on 1.04.2013		9,800
Cash at bank as on 1.04.2013		17,600
Subscription :		
2012-13	7,500	
2013-14	28,600	
2014-15	6,400	42,500
Entrance Fees		4,000
Life membership Fees		8,000
Donations		35,000
Sale of old Bats and Balls		2,200
Printing and stationery		2,500
Electricity Charges		3,600
Telephone Charges		4,200
Wages and Salaries		14,000
Interest on Investments		2,000

Notes

Lockers Rent	2,800
Purchase of Sports Material	20,000
Purchase of Government Securities	40,000
Cash in hnad as on 31.0.3.2014	7,200
Cash at bank as on 31.03.2014	32,400

Solution :

Receipts and Payments A/c

for the year ended 31st March 2014

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
Balance b/d		Printing & Stationery	2,500
Cash in hand	9,800	Electricity Charges	3,600
Cash at bank	17,600	Telephone Charges	4,200
Subscription		Wages and Salaries	14,000
2012-13 7,500		Purchases of Sports Material	20,000
2013-14 28,600		Purchase of Government	
2014-15 6,400	42,500	Securities	40,000
Entrance Fees	4,000	Balance c/d	
Life membership Fees	8,000	Cash in hand	7,200
Interest on Investments	2,000	Cash at bank	32,400
Locker Rent	2,800		
Donations	35,000		
Sales of old Bats and Balls	2,200		
	1,23,900		1,23,900

INTEXT QUESTIONS 19.4

(i) In the cash Book, one type of item may appear for a number of times, how many times does an item appear in Receipts and Payments Account?

(ii) Subscription of ₹ 2,000 has been received for 2013 and ₹ 150 for 2014. How much amount will be shown as subscription received in the Receipts & Payments Account for 2013?

(iii) Is Life Membership Fees an item of Receipt or Payment Account?

Notes

WHAT YOU HAVE LEARNT

- Not-for-Profit Organisations are sports clubs, charitable institutions, schools, welfare societies, health clubs, blood banks, etc.
- Their objective is to serve its members and public in general.
- Summary of Cash Book entries for the year when presented in the form of an Account is called Receipts and Payments A/c.
- All cash transactions are recorded in Receipts and Payments Account irrespective of the transaction being of capital nature or revenue and whether belong to current year or preceeding or succeeding year.
- Receipts and Payments Account is the Cash Book in summary form and becomes the basis of preparing Income and Expenditure A/c and balance Sheet of a Not for Profit organisation.
- Specific items of receipts are subscription, entrance fees, Life membership fees, Endowment fund, Donations, Legacy, sale of old newspapers, government grant, etc. Specific items of payments are purchase of fixed assets, consumable stores, honorarium, etc.

TERMINAL EXERCISE

1. State the meaning of Not-for-Profit organisations and explain in brief the various characteristics of Not-for-Profit Organisations (NPOs).

2. Explain in brief the terms :

   (a) Legacy (b) Honorarium

   (c) Subscriptions (d) Specific Donation

3. State the meaning of Receipts and Payments Account. Explain the need for preparing Receipts and Payments Account.

4. Distinguish between Receipts and Payaments Account and Cash Book.

5. From the information given below prepare Receipts and Payments A/c of 'Friends in Need' a Non-Government organisation (NGO) for the year ended 31st December, 2013.

Details	₹
Cash in hand on 1st Jan, 2013	4,000
Entrance fees	1,400
Donations	15,000
Subscription	15,000
Electricity charges	1,500
Salaries6,500	
Honorarium to Secretary	4,500
Petty Cash Payments	1,800
Paid into Bank as Fixed Deposits	15,000
Insurance Premium	2,100
Grant from the Government	40,000
Stationery	1,200

6. Following are the extracts taken from the Cash Book of HOPE of Kolkata, an organisation looking after the welfare of widows and AIDs patients. Prepare Receipts and Payments Account for the year ended 31st March, 2014.

			₹
Balance as on 1st April 2013			48,500
Subscription :			
	2012-13	8,000	
	2013-14	42,000	
	2014-15	5,000	55,000
Donations			1,20,000
Grant in Aid			2,00,000
Legacy			80,000

Receipts from the sale of stitched clothes	32,000
Receipt from the sale of Bakery items	46,000
Wages and Salaries	12,000
Electricity Charges	8,600
Fuel	16,400
General Expenses	9,700
Maintenance of Building	6,000
Insurance Premium	4,000
Laundary Expenses	3,200
Construction of Rooms	1,25,000
Government Bonds	2,50,000
Food	1,20,000
Balance in the Bank A/c	1,00,000

ANSWERS TO INTEXT QUESTIONS

19.1 (i) X (ii) √ (iii) √

19.2 **I.** Receipts : Donation, subscription, Legancy
Payments : Charity, Purchase of Books, Honorarium

II. (i) Need (ii) Characteristics
(iii) Characteristics (iv) Need

19.3 **Receipts & Payments A/c**

Receipts	*Amount* ₹	*Payments*	*Amount* ₹
Opening Balance	1,800	Wages	800
Subscription	3,600	Purchase of Books	2,400
Entrance fees	400	Telephone Charges	600
Sale of Newspapers	200	Closing Balance	2,500
Interest on Fixed Deposit	300		
	6,300		6300

19.4 (i) Once (ii) ₹ 2,150 (iii) Yes, Receipt

Notes

ANSWERS TO TERMINAL EXERCISE

5. Closing cash balance ₹ 15,200

6. Closing cash balance ₹ 46,600

ACTIVITY

Visit at least five Not for Profit Organisations of your city/town/area engaged in the following activities

(a) Conservation of forest and wild animals.

(b) AIDS awareness

(c) Girl child education

(d) Sports club

and collect the following information :

Name of the organisation	*Nature of main activity engaged in*	*Main source of Revenue*

Notes

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20

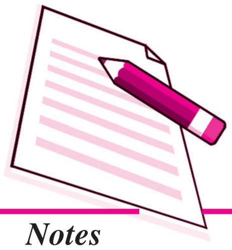
FINANCIAL STATEMENTS (NOT FOR PROFIT ORGANISATION)

You have learnt that Not for Profit Organisations (NPOs) such as Clubs, Hospitals, Blood Banks, Schools, Non-Governmental Organisations (NGOs) creating awareness among people about HIV/AIDs also involve in financial activities. They also maintain books of account to record them and also prepare financial statements at the close of the year. These statements are Receipts and Payments Account, Income and Expenditure Account and Balance Sheet. In the previous lesson, you have learnt the meaning and need for preparing Receipts and Payments Account, items to be taken and also its preparation. In this lesson you will learn about Income and Expenditure Account and Balance Sheet of Not for Profit Organisations (NPOs).

OBJECTIVES

After studying this lesson you will be able to :

- explain the meaning and need of Income and Expenditure Account;
- draw the format of Income and Expenditure Account;
- identify and explain the items exclusive to Income and Expenditure Account;
- prepare Income and Expenditure Account from the given information;
- explain the various adjustments and their incorporation while preparing Income and Expenditure Account;
- distinguish between Receipts and Payments Account and Income and Expenditure Account;
- prepare the Balance Sheet of a Not for Profit Organisation (NPOs).



Notes

20.1 INCOME AND EXPENDITURE ACCOUNT : MEANING, NEED AND ITEMS

Meaning

It is the summary of incomes and expenditures of the organisation of a particular year and is prepared at the end of the year. This account is similar to the Profit and Loss Account of the Business Organisations. In this account revenue expenditure and revenue income of the year for which Income and Expenditure A/c is prepared are taken. That means any amount of these items pertaining to either previous year or next year are not considered. The balance amount of this account is either surplus or deficit. If the income side of this account exceeds the expenditure side, the difference is 'surplus'. In case the expenditure side exceeds the income side, the difference is 'deficit'.

Need of preparing Income and Expenditure Account

Even the Not for Profit Organisations would like to know the net result of their activities of a particular period which generally is one year. Though such organisations do not engage in trading activities and their objective is not earning profits, yet they would like to know whether income exceeds expenditure or vice a versa. The amount of the such difference is not termed as Net Profit or Net Loss as it is so termed in case of business organisations. In case of Not for Profit organisations the net result is termed as 'surplus' or 'deficit' as the case may be. Moreover of a preparation of Income and Expenditure Account is a legal requirement. It helps the organisations to control their expenditure.

Format of Income & Expenditure with some important items

Income and Expenditure A/c of ....
for the year ended 31st March ....

Dr. Cr.

Expenditure	*Amount* ₹	*Income*	*Amount* ₹
Rent		Subscriptions received during the year	
Less : paid for last years outstanding		*Less :* received on account of last year	
Less : paid for next year		*Less :* received on account of next year	
Add : current year outstanding		*Add :* subscription outstanding for current year	
Add : for current year paid in last year			
On account of current year salaries			
Newspaper expenses			

Notes

Loss on sale of furniture		*Add :* subscription received	
Depreciation		last year on account of	
Any other item of revenue expenses		current year	
Expenses on consumable		Donations	
material say stationery		Grant in aid	
Surplus-excess of income		Sale of Grass	
or expenditure		Interest on Investment	
		Miscellaneous Receipts	
		Sale of old newspapers	
		Revenue incomes	
		Deficit : excess of expenditure	
		over income	

Relevant Items of Income and Expenditure

Following are the relevant items of income of a Not for Profit Organisations (NPO).

1. **Subscription :** It is a periodic contribution by members of the organization
2. **Entrance fees/Admission fees :** It is received from members at the time of their admission to the organisation.
3. **Donations :** Donation is the amount received from person, firm, company etc. by way of gift. But only general donation that too of smaller amount and of recurring nature is treated an item of revenue income.
4. **Sale of old newspapers, sports material, etc. :** Sale of old newspapers or condemned books, sports material etc. is treated as an item of revenue income.
5. **Interest receipt :** The surplus funds may be kept in a fixed deposit account in a bank or invested elsewhere. Interest received thereon is an item of revenue income.
6. **Grant-in-Aid :** Local, state and central government and some government agencies give money as grant-in-aid to Not-for-Profit Organisations (NPOs).

Apart from these, there are numerous other items like rent of hall, sale of grass, income from entertainment, etc.

Items of Revenue Expenses

Some important items are as follows :

1. Salaries, wages, rent, stationery, postage, telephone charges, electricity charges are some items of revenue expenses which are common to all Not for Profit Organisations (NPOs).

2. **Honorarium :** It is the amount paid to the person who looks after the functioning of the organisation but is not the employee of the company.

3. **Depreciation :** Depreciation is provided on the fixed assets such as furniture, building and books, etc.

4. Expenses on tournament, fair, etc.

5. Other items

There are numerous other items depending upon the nature of organisation. For example, upkeep of ground if it is a sports club, medicines, laundry if it is a hospital and so on.

INTEXT QUESTIONS 20.1

I. Classify the following items into income and expenditure :

(a) Honorarium	(b) Grant-in-aid	(c) Sale of old newspapers
(d) Subscription	(e) Lockers rent	(f) Insurance Premium

II. Write 'R' if the statement is correct and 'W' if it is incorrect :

(i) The excess of the income over expenditure is called Net Profit

(ii) All items of receipts are entered on income side of Income and Expenditure Account and all items of payments are written on the expenditure side of Income and Expenditure Account.

(iii) Income and expenditure account is prepared to know the net result of the activities of Not for Profit organisations involving finance.

(iv) Entrance fees is an item of income.

(v) Specific donation is an item of revenue income

20.2 PREPARATION OF INCOME AND EXPENDITURE ACCOUNT

In the previous section the format of Income and Expenditure Account and the items that are usually entered in the account have been explained. Now you will learn how to prepare Income and Expenditure Account from the given items. This account is prepared from Receipts and Payments account and additional information if any. While preparing an Income and Expenditure account, the following important points have to be kept in mind :

A. Steps for Expenditure side : The payment column of Receipts and Payments Account contains both revenue items as well as capital items. Revenue items such as rent paid salary, telephone charges etc. will be entered on the expenditure side of Income and Expenditure Account.

If necessary, adjustments will be made in these items for expenses that are outstanding at the end of the current year and/or were outstanding at the end of the previous year. Adjustment will also be made for prepaid expenses at the end of previous year as well as those at the end of current year.

Notes

B. Steps for Income side : The receipt column contains items of revenue receipts as well as capital receipts. Revenue receipts are entered in the income column of the Income and Expenditure Account. Example of such items are subscription, interest on investment, entrance fees etc.

These items need to be adjusted for the amount received for the previous year or for the next year. Similarly, adjustment should be made for outstanding income both at the current year and at the end of the previous year.

There may be other adjustments such as bad debts, depreciation, etc. will also be entered in the expenditure column.

C. Surplus or Deficit : Finally, this account is balanced i.e. difference of the totals of two amount columns is worked out. If credit side is more than the debit side the difference amount is written on its debit side as surplus and if debit side exceeds the credit side, the difference is deficit and is written on the credit side of the account.

Illustration 1

Prepare Income and Expenditure A/c from the following information of Promising Sportsmen's Club, Delhi for the year ending 31st December, 2013

	₹
Cash balance as on 1.1.2013	7,000
Subscriptions	30,000
Interest received	2,500
Sports material	24,000
Match fund	15,000
Donations	2,000

Sale of grass	300
Newspaper expenses	600
Investments purchased	10,000
Salaries paid	16,000
Rent paid	5,400
Miscellaneous receipts	600
Telephone charges	1,200
Cash balance as on 31.12.2013	200

Solution :

Books of Promising Sportmen Club

Income & Expenditure A/c

for the year ending 31st Dec., 2013

Dr. Cr.

Expenditure	*Amount* ₹	*Income*	*Amount* ₹
Salaries	16,000	Subscriptions	30,000
Rent	5,400	Interest Received	2,500
Newspaper Expense	600	Sale of grass	300
Telephone charges	1,200	Miscellaneous receipts	600
Surplus excess of income over expenditure	12,200	Donation	2,000
	35,400		**35,400**

Illustration 2

Prepare Income and Expenditure Account from the Receipts and Payments Account of Youngsters Health Club, Jhansi for the year ending 31st December, 2013.

Receipt & Payment A/c

Receipts	*Amount* ₹	*Payment*	*Amount* ₹
Opening balance	2,400	Rent	3,600
Subscriptions	16,000	Stationery	450

Entrance fees	200	Salary	4,800
Sale of Investments	8,000	Purchase of Equipments	5,500
Sale of old Almirah	800	Expenses on competitions	2,800
(Book value Rs 1800)		Miscellanceous Expenses	650
Donation	2,500	Furniture Purchased	4,000
		Closing balance	8,100
	29,900		**29,900**

Notes

Solution:

Books of Youngsters Health Club

Income & Expenditure A/c

for the year ending 31st Dec., 2013

Expenditure	*Amount* ₹	*Income*	*Amount* ₹
Rent	3,600	Subscription	16,000
Stationery	450	Entrance fees	200
Salary	4,800	Donations	2,500
Expenses on competitions	2,800		
Miscellaneous Expenditure	650		
Loss on sale of almirah	1,000		
Surplus (excess of Income over expenditure)	5,400		
	18,700		**18,700**

INTEXT QUESTIONS 20.2

Answer the following in one word :

(i) To which side of the Income & Expenditure A/c items of revenue expenses are taken?

(ii) What term is given to the amount by which credit side of Income and Expenditure Account exceeds its debit side?

(iii) Which side of the Income and Expenditure A/c is the side of Income?

(iv) From which side of Receipts and Payments A/c is taken the item of entrance fees to the credit of Income and Expenditure A/c?

Notes

20.3 ADJUSTMENT OF ITEMS IN INCOME AND EXPENDITURE ACCOUNT

Income and Expenditure A/c is prepared on the basis of Receipts and Payments A/c but there may be certain items which are not included in Receipts and Payments A/c. However these need to be incorporated in Income and Expenditure A/c. Following are some of the most common adjustments to be carried out :

1. Subscription Received

It is an item of income and is of recurring nature. It appears on the Receipts side of the Receipts and Payments account. It may include arrears of previous years which is received in the current year and may also include amount received for next year in advance. There may be an amount outstanding for the current year. Some members might have paid current year's subscription during the previous year.

For the purpose of preparing Income and Expenditure Account, subscription for the current year only is to be taken into account. Hence, there is a need for adjustment to be made for the above reasons.

Various adjustments relating to subscription are made in the following manner :

i. ***Subscription outstanding for current year***

Journal entry

Subscriptions outstanding A/c Dr
To Subscriptions A/c
(Subscription for current year due but not received)

Adjustment in Income and Expenditure A/c

Income and Expenditure A/c

Dr. Cr.

Expenditure	*Amount*	*Income*	*Amount*
		Subscription *Add:* outstanding for current year	

This amount will be added to subscriptions received in Income and Expenditure Account and will be shown on the Asset side of the Balance Sheet.

Notes

ii. Subscription due in the previous year but received during the current year

Journal entry

Subscription A/c Dr

To Subscription Outstanding A/c

(Adjustment of subscription due in last year but received in the current year)

Illustration 3

	₹
Subscription received during the year 2013	15,000
Subscription outstanding as on 31st December 2013	1,500
Subscription received in the year 2012 on account of year 2013	800
Subscription received in the year 2013 for outstanding amount of the year 2012	400
Subscription received in the year 2013 for the year 2014	600

Calculate the amount of subscription received to be shown in the Income and Expenditure Account for the year adding 31st Dec, 2013.

Solution :

Subscription received during 2013	15,000
Add : current years outstanding	1,500
Add : received in 2012 for 2013	800
Less : received for 2012	400
Less : advance for 2014	600
Subscription to be shown in Income & Expenditure Account for 2013	16,300

Subscription Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
Subscription outstanding A/c 2012	400	Cash	15,000
Subscription received in		Subscription out standing A/c	1,500
Advance A/c 2014	600	Subscription received in	
Income & Expenditure A/c	16,300	Advance A/c (2012)	800
	17,300		17,300

Notes

2. Rent Paid

Rent paid is an item of expenditure. It may also require some adjustments in rent. The adjustments required to made to be the amount of rent paid during the year may be as follows :

(i) Rent outstanding for the current year

(ii) Rent paid in the current year as advance for the next year

(iii) Rent paid in the current year on account of the outstanding amount in the previous year

(iv) Rent paid in the previous year on account of current year.

Journal entries in the books will be made as follows :

(i) Rent A/c Dr.
  To Rent outstanding A/c
 (Rent due but not paid)

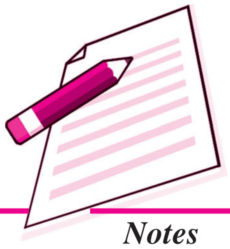
(ii) Rent paid in advance A/c Dr.
  To Bank A/c
 (Rent paid in advance for for the year)

(iii) Rent outstanding A/c Dr.
  To Bank A/c
 (Amount paid for outstanding rent of the previous year)

(iv) Rent A/c Dr.
  To Rent paid in Advance
 (Rent paid in advance last year being transferred to Rent A/c)

Calculation of Rent Amount to be shown for current year in the Income and Expenditure Account.

Rent paid in the current year		√
Add : Rent paid in advance in the previous year for current year	+	√
Add : Rent due in current year but not paid	+	√
Less : Outstanding Rent paid for previous year in current year	–	√
Less : Advance rent paid for next year in current year	–	√
Amount of rent to be debited to Income and Expenditure A/c		x x x x



Notes

Illustration 4

A club has paid rent of ₹ 20000 in the year 2013. Rent still to be paid amounts to ₹ 2,000. Amount of ₹ 1,500 was paid in 2012 on account of the year 2013. Calculate the amount to be taken to Income & expenditure A/c of 2013.

Solution :

	₹
Rent paid in 2013	20,000
Add Rent outstanding for 2013	2,000
Add Rent paid in advance in 2012 for the year 2013	1,500
Rent for 2013 to be charged to Income and Expenditure A/c	23,500

Depreciation on Assets

Depreciation is a non cash item. It is to be charged on every fixed asset such as Land & Building, Furniture, Books etc. every year as per predetermined method. The amount of depreciation is shown on the expenditure side of the Income & Expenditure Account and is deducted from the respective value of the asset while showing it on asset side of the Balance Sheet.

Journal Entry for the same will be

1. Depreciation A/c
   To Asset A/c

2. Income and Expenditure A/c
   To depreciation A/c

Illustration 5

The following is the Receipts and Payments Account of Help AID Society of India for the year ended 31st December, 2013.

Receipts and Payments A/c

Dr. Cr.

Receipts	*Amount* ₹	*Payments*	*Amount* ₹
Balance b/d	8,400	Salaries	12,000
Subscriptions	7,800	Rent	6,000
Entrance fees	600	Purchase of Vans	28,000

Government Grant	30,000	Expenses of Motor Vans	6,400
Donation for Building Fund	25,000	Laundry charges	5,200
Interest Received	2,400	Drugs and incidental charges	9,600
		Publicity expenses	4,000
		Balance c/d	3,000
	74,200		74,200

Additional Information

1. Subscription outstanding amounted to ₹ 1,500
2. Interest accrued but not received ₹ 600
3. Salary outstanding is ₹ 1,200
4. Provide depreciation on Motor Van @ 20%

Prepare Income & Expenditure A/c.

Solution :

Books of Help AID Society of India

Income & Expenditure A/c

for the year ending December 31, 2013

Dr. Cr.

Expenditure		*Amount* ₹	*Income*		*Amount* ₹
Salaries	12,000		Subscription	7,800	
Add : Outstanding	1,200	13,200	*Add :* outstanding	1,500	9,300
Rent		6,000	Entrance fees		600
Expenses of Motor Van		6,400	Government Grant		30,000
Laundry charges		5,200	Interest	2400	
Drugs and incidental charges		9,600	*Add :* Interest Accrued	600	3000
Publicity Expenses		4,000	Deficit i.e. excess of expenditure		
Depreciation on Motor Van		5,600	over income		7100
		50,000			50000

After learning about Receipts and Payments A/c and Income Expenditure A/c in detail, we can now distinguish between the two. Following are the differences.

Difference between Receipts and Payments A/c and Income and Expenditure A/c

Basis of Difference	*Receipts and Payments A/c*	*Income and Expenditure A/c*
1. Nature	It is a summary of the Cash Book.	It is the summary of Revenue Income and Revenue Expenditure.
2. Side	Debit side of this account shows receipts and credit side shows payments.	Debit side of this account shows expenses and losses and credit side shows incomes and gains.
3. Opening Balance	It starts with the opening balance of Cash in hand or cash at bank.	There is no balance in the beginning.
4. Closing Balance	Closing balance of this account shows Cash in hand or cash at Bank.	Closing balance of this account shows Surplus or deficit.
5. Capital and Revenue Items	In Receipts and payments A/c, both capital and revenue nature of items are recorded.	In Income and expenditure A/c, only revenue nature items are recorded.
6. Adjustment	Adjustments are not considered while preparing it.	It is necessary to consider adjustments while preparing it.
7. Transfer of closing balance	Closing balance of this account is transferred to the Receipts and Payment A/c for the next period.	Closing balance of this account is transferred to the capital fund general fund in the Balance Sheet.

Notes

INTEXT QUESTIONS 20.3

I. A Clubs collects from its 500 members subscription @ ₹ 100 per member every year.

(a) It has received ₹ 1,500 last year on account of current year. 20 members have not paid their due for the current year. Calculate the amount received on account of subscription.

Notes

(b) Rent of ₹ 11,000 has been paid in the current year ₹ 20,000 is still to be paid. ₹ 9,000 was outstanding last year. Calculate the amount to be written as Rent paid in the current year.

II. (a) Closing balance of Receipt and Payment account is transferred to the same account for the next year, where is the balance of Income and Expenditure transferred?

(b) Income and Expenditure Account is the summary of Revenue Income and Revenue Expenditure then Receipt and Payment Account is the summary of what?

(c) Closing Balance of receipts and Payments Account shows the cash in hand/ bank what does the closing balance of Income and Expenditure Account show?

(d) Income and Expenditure Account does not start with any opening balance. What is the opening balance with which Receipt and Payment Accounts started?

20.4 PREPARATION OF BALANCE SHEET

Not for Profit Organisations (NPOs) also prepare Balance Sheet at the end of the year. The Balance Sheet prepared by a Not for Profit Organisation (NPOs) is not different from that which is prepared by for Profit Organisation. It has two sides (a) Assets side and (b) Liabilities side. It has only capital items i.e. Assets, liabilities and Capital fund.

The objective of preparing a balance sheet by a Non for Profit Organisation is to show the financial stability, strength and soundness on the last date of the accounting year.

The format of the balance Sheet is given below

Balance Sheet of ....

As at 31st Dec. ....

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Rent outstanding		Cash in hand	
Salary outstanding		Cash at Bank	
Subscription Received in advance		Fixed Deposits	

Notes

Building fund		Subscription outstanding	
Capital fund/General fund		Sports material	
Add : Life membership fee		Books	
Add : Surplus or Less Deficit		Furniture	
		Building	

Income and Expenditure A/c and the Balance Sheet of NPOs is prepared from the Receipts and Payments Account and the additional information. While preparing Balance Sheet of a Not for Profit organisations (NPOs) certain points are to be kept in mind which are as follows :

1. Assets appearing in the preceding years balance sheet need to be adjusted for any sale or purchase of the asset made during the year and the depreciation provided on the particular asset. Only the adjusted amount will appear in the Balance Sheet of the current year.
2. If any new asset has been purchased during the year it will appear on the payment side of Receipts & Payments A/c, therefrom it is taken to the Balance Sheet.
3. If any loan has been raised it will appear on the receipt side of Receipts and Payments A/c and repayment on its payment side. Net amount will be shown on the liability side of the balance sheet. In the same manner if any advance has been made to a person and some repayment has been made by a person, it will be shown on the Asset side of the Balance sheet at the net amount.
4. Any adjustments made regarding expenses and/or regarding incomes such as outstanding or prepaid will be shown in the Balance Sheet.
5. Any item of liability appearing in the previous years Balance Sheet will be shown at its net value i.e. after deducting from it the amount paid against them.
6. Special receipts like donations for Building etc. will not be treated as income. It will be shown as a fund meant for a special purpose on the liability side of the Balance Sheet.
7. Capital General fund taken from the last balance sheet will be shown after adjusting for the current years ‘surplus’ or ‘deficit’.

One important point regarding preparing balance sheet is that before preparing Income and Expenditure Account and Balance sheet of a Not for Profit organisation (NPOs) for the current year. Capital General fund carried forward from the last year should be considered. Besides this, other items of liabilities and assets carried from last year are also need to be adjusted. For this Balance Sheet of the previous year will be drawn with the help of given information. This is termed as opening Balance Sheet. An opening Balance Sheet will be prepared as per following illustration.

Illustration 6

Information as on 31st December, 2013 of 'All Green Ever Green' an NGO working for the preservation of forests is given as under :

Details	₹
Cash in hand	1,400
Cash at Bank	21,800
Books	78,000
Furniture	16,000
Computer	24,000
Subscription outstanding	2,600
Fixed deposit with Bank	1,00,000
Subscription Received for 2014	3,800
Rent outstanding	4,000
Publicity fund	35,000
Building fund	80,000

Solution :

Balance Sheet of 'All Green Ever Green'
as at 31st December, 2013

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Subscription received in advance	3,800	Cash in hand	1,400
Rent outstanding	4,000	Cash at Bank	21,800
Publicity fund	35,000	Subscription outstanding	2,600
Building fund	8,0000	Books	78,000

Capital General fund (Bal. Fig.)	1,21,000	Furniture	16,000
		Computer	24,000
		Fixed Deposit with Bank	1,00,000
	2,43,800		2,43,800

INTEXT QUESTIONS 20.4

Answer the following Questions

1. For what the assets need to be adjusted before showing them in the Balance Sheet?
2. On which side of the Balance Sheet loan item appearing on the Receipts side of Receipt and Payment Account will be shown?
3. For what items the capital fund for the years Balance Sheet will be adjusted?
4. At what value the liability of last years balance sheet will be shown in the current years balance Sheet?

WHAT YOU HAVE LEARNT

- Income and Expenditure Account is similar to Profit and Loss Account. Income and Expenditure Account is the summary of Incomes and Expenditures of a Not for Profit Organization (NPO) of a particular year.
- Income and Expenditure Account is prepared to know the net result of the financial activities of Not for Profit Organisations (NPOs) which may be either surplus or Deficit.
- Important items of expenditure are revenue expenses such as salary, postage, stationery, honorarium, depreciation etc. Main items of incomes are subscription, entrance fees etc.
- All adjustments such as outstanding, prepaid etc. are incorporated before arriving at the surplus or deficit.
- Receipts and Payments Account and Income and Expenditure Account can be differentiated on the basis of nature, side, opening balance, closing balance, capital and Revenue items adjustments and transfer of closing balance.

- Every Not for Profit Organization (NPO) prepares Balance Sheet at the end of the year. It also has the asset side and the liability side. Opening balance sheet is required to prepare Balance Sheet for the current year.

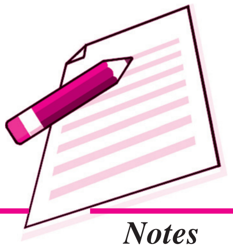
TERMINAL EXERCISE

1. What is an Income and Expenditure Account?
2. Explain the objectives of preparing Income and Expenditure Account.
3. List the various items of income and expenditure of a Not for Profit Organisations (NPOs).
4. Describe in brief the steps taken to prepare Income and Expenditure Account.
5. Differentiate between Receipt and payment Account and Income and Expenditure Account on the basis of

   i. Nature   ii. Adjustment
   iii. Side   iv. Transfer of closing balance.

6. Prepare Receipts and Payments Account from the information given below:

	₹
Cash in hand on 1.1.2013	3,600
Cash at bank on 1.1.2013	10,000
Subscription	6,000
Entrance Fees	1,000
Wages paid to labourers	800
Salaries paid to clerks	3,000
Electricity	1,500
Conveyance	600
Honorarium to Secretary	1,200
Printing and Stationery	500
Fixed Deposit made with bank	10,000



7. What amount will you post to Income and Expenditure Account from the information given below for the year 2013?

	₹
Subscription received during 2013	10,000
Subscription due in 2012	2,000
Subscription received in 2012 for 2013	400
Subscription received in 2013 for 2014	600
Subscription due for 2013	1,000

8. How will you show the followings in the Income and Expenditure Account?

   (i) Rent paid in the Current year ₹ 6,000

   (ii) Rent due in Current year ₹ 800

   (iii) Rent paid last year for this year ₹ 600

   (iv) Rent due of last year paid in this year ₹ 2,000

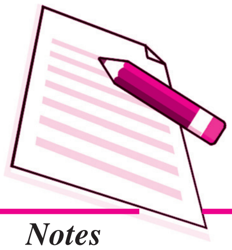
   (v) Advance rent paid for next year in this year ₹1,600

9. From the Receipts and Payments Account and the information given, prepare Income and Expenditure Account and Balance Sheet of Shrey Blue Star Club:

Receipts and Payment Account

for the year ended 31 st December, 2013

Receipts	*Amount* ₹	*Payments*	*Amount* ₹
Balance b/d	1,500	Electricity	1,500
Subscriptions:		General Expenses	1,250
2012	500	Honorarium to Secretary	1,250
2013	8,000	Books	2,250
2014	450	Newspapers	500
Sale of Newspapers	250	Furniture (Purchased)	1,000
Sale of old Furniture (Book value ₹ 300)	200	Fixed Deposit made with bank on 1.1.2013 @ 5%p.a.	4,000



Notes

Rent received for the use of Hall	1,750	Balance c/d	2,400
To Profit from Entertainment	1,500		
	14,150		14,150

Information

(i) The club has 160 members each paying annual subscription of ₹100.

(ii) Subscription outstanding on 31.12.2012 ₹ 1350

(iii) On 31.12.2013 General Expenses outstanding amounted to ₹ 50.

(iv) On 1.1.2013 the club owned Building valued at ₹ 40,000, Furniture ₹ 2,000 and Books ₹ 6000.

10. How will you show the following in the Income and Expenditure Account?

(i) Rent paid in the Current year ₹ 1,000

(ii) Rent due in Current year ₹ 200

(iii) Rent paid last year for this year ₹ 300

(iv) Rent due of last year paid in this year ₹ 500

(v) Advance rent paid for next year in this year ₹ 400

11. From the Receipts and Payments Account and the information given, prepare Income and Expenditure Account and Balance Sheet of Sports Club:

Receipts and Payment Account

for the year ended 31st December, 2013

Receipts	*Amount* ₹	*Payments*	*Amount* ₹
Balance b/d	5,100	Purchase of sport equipment	5,000
Subscriptions:		Electricity	1,500
2012	800	General Expenses	2,250
2013	3,000	Honorarium to Secretary	3,250
2014	1,250	Books	4,250
Sale of newspapers	250	Newspapers	600
Life membership	6,000	Furniture (Purchased)	4,000
Sale of old Furniture (Book value ₹ 600)	400	Fixed Deposit made with bank on 30.6.2013 @ 8%	10,000
Rent received for the use of Hall	2,750	By Balance c/d	2,200

Govt. Grant	10,000		
Profit from Entertainment	3,500		
	32,450		32,450

Additional Information

(i) The club has 100 members each paying annual subscription of ₹100.

(ii) On 31.12.2013 General Expenses outstanding amounted to ₹ 250.

(iii) On 1.1.2013, the club owned Building valued at Rs.10,000, Furniture ₹ 12,000 and Books ₹ 6,000

(iv) Sports equipments ₹ 2,400 as on 1.1.2013. Depreciation was to be allowed on furniture @ 5%. Sports equipment at the end of the year were ₹ 3,600.

ANSWERS TO INTEXT QUESTIONS

20.1 **I.** Income : Grant-in-aid, sale of old newspapers, subscription, locker rent
Expenditure : Honorarium, Insurance premium

II. (i) W (ii) W (iii) R (iv) R (v) W

20.2 (i) Expenditure (debit) (ii) Surplus (iii) Credit (iv) Receipts

20.3 **I.** (a) ₹ 46,500 (b) ₹ 22,000

II. (a) Balance Sheet as Surplus / Deficit (b) Cash / Bank A/c
(c) Surplus / Deficit (d) Cash / Bank

20.4
1. Sale/purchase in the current year and depreciation provided
2. Liability side
3. For surplus/deficit
4. At net value i.e. after deducting from it the amount paid against them.

ANSWERS TO TERMINAL EXERCISE

6. Closing cash in hand ₹ 3,000
7. Subscription ₹ 8,800 to posted
8. Rent to be ₹ 3,800 posted
9. Surplus ₹ 15,050, Capital fund (opening) ₹ 50,850
   Total Balance Sheet ₹ 64,400
10. Rent : ₹ 600
11. Surplus ₹ 14,250 Capital fund (opening ₹ 36,300)
    Total Balance Sheet ₹ 58,050

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21

ACCOUNTS FROM INCOMPLETE RECORDS

We have studied so far the Double Entry System of accounting. According to this system, both the aspects of a transaction are recorded. Another system of recording transactions called Single Entry System also exists, under which both the aspects of a transaction may not be recorded. Unlike Double Entry System in Single Entry system, no set rules are followed. Even the books of account to be maintained are not certain. Usually, under this system the cash book and personal ledgers are maintained : real and nominal accounts are not. In this system because both the aspects of transactions are not recorded the system is known as 'Accounts from Incomplete ecords' or 'Single Entry System of Accounting'. Sometimes accounts that had been maintained, on double entry system may be rendered incomplete because of the happening of certain events like fire, floods, earthquakes etc. Accounting records that are not maintained according to Double Entry System are known as Accounts from Incomplete Records or Single Entry System of Accounting.

OBJECTIVES

After studying this lesson you will be able to:

- state the meaning of Single Entry System;
- explain uses and limitations of Single Entry System/Accounts from Incomplete Records;
- explain ascertainment of profit/loss by conversation method.
- ascertainment of profit /loss by statement of affairs method;
- ascertain the missing figures of total debtors, total creditors, B/R A/c and Cash Book;

- ascertain capital with begining by preparing opening statement of affair and
- prepare final accounts.

21.1 DEFINATION

Kohler defines Single Entry System as, "*A system of book keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances.*"

Sometimes, the term Single Entry System is mistakenly understood that under this system only one aspect of a transaction is recorded in the books. This is not ture. The fact remains that under this system, while for certain transactions both the aspects are recorded, for others only one aspect is recorded and some trasactions are even ignored.

Features

The features of the Single Entry System are as follows :

i. **Suitability :** This system is suitable for small businesses such as sole trader or partnership firm. Limited companies due to legal provisions, cannot maintain accounting books on Single Entry System.

ii. **Preparation of Cash Book :** Generally, a Cash Book is prepared in this system in which business as well as private transactions are mixed up.

iii. **Preparation of Personal Accounts :** Normally under this system, only personal accounts are prepared and real and nominal accounts are avoided.

iv. **No Uniformity :** This system may differ from firm to firm, because same principles are not followed by all the enterprises.

v. **Requirement of Original Vouchers :** Usually under this system, we have to depend on originally vouchers for collecting the necessary informations.

vi. **Preparation of Final Accounts :** In the absence of all nominal and real accounts the final accounts cannot be prepared easily. It is posible after converting the available information into double entry system and missing amounts are determined then Trading & Profit & Loss A/c can be prepared. The amount of all assets and all liabilities can also be computed from incomplete records, but they are based on estimates. That is the reason that the statement of assets and liabilities prepared under this system at the end of an accounting period is called a Statement of Affairs instead of Balance Sheet.

21.2 USES OF SINGLE ENTRY SYSTEM

Uses of Single Entry System are as follows :

i. **Simple Method :** Single entry is a very simple method of recording business transactions.

ii. **Less Expensive :** It is less expensive when it is compared to Double Entry System of book keeping.

iii. **Suitable for Small Concerns :** It is mainly suited to small business concerns with limited number of transactions and very few assets and liabilities.

iv. **No Need of Knowledge of Principles of Book Keeping :** Under Single Entry System, accounting records can be easily maintained as their maintenance does not require knowledge of the principles of book keeping.

v. **Easy to Ascertain Profit or Loss :** Ascertainment of profit or loss in much easier. To ascertain profit or loss, the proprietor has to compare the financial position of business at the close of the accounting period with that at the beginning.

Notes

Limitations of Single Entry System

Single Entry System provides the incompleteness and in sufficiency of information, hence it has the following limitations :

i. **Arithmetical Accuracy Cannot be Proved :** Trial Balance can not be prepared and hence, arithmetical accuracy of books cannot be proved or tested. Chances of error, mischief of fraud remaining undetected are high.

ii. **No Control on Assets :** Since asset accounts are not maintained, it may be difficult to keep full control, in order to avoid misappropriations of assets.

iii. **True Profits cannot be Known :** Trading and Profit and Loss Account cannot be prepared and hence, the correct profit earned or loss suffered during the accounting period is not known.

iv. **Financial Position of the Business cannot be Judged :** Balance Sheet, called Statement of Affairs under Single Entry System, is prepared in an unsatisfactory manner. The asets and liabilities are not provided from records but are put down by physical inspection and on estimated basis. Hence, Balance Sheet cannot be drawn up with a view to ascertaining the true financial position of the business on a particular date. Thus, exact position of total net assets cannot be known.

v. **No Internal Check :** Since internal check is not possible, the method gives enough room for errors and frauds, besides their detection is very difficult.

vi. **Difficult to Ascertain the Business Value :** The records being inadequate, it is difficult to value the business, especially goodwill.

vii. **Inadequate for Planning and Control :** Accounting information supplied by the accounting records is inadequate for managerial planning and control.

viii. **Incomplete and Unscientific System :** This system is incomplete and unscientific as both the aspects fo a transactions are not recorded and no set rules are followed for recording them.

ix. **Comparative Study is Difficult :** A major defect of this system is that the financial position of the current year cannot be compared with that of the previous year due to incomplete information of transactions of business.

INTEXT QUESTIONS 21.1

I. Fill in the blanks with appropriate words :

i. The assets and liabilities are put down by physical and __________.

ii. Single Entry System is a very ___________ method of recording business transactions.

iii. Single Entry System is ____________ expensive as compared to Double Entry System of book keeping.

II. State whether the following statements are true or false :

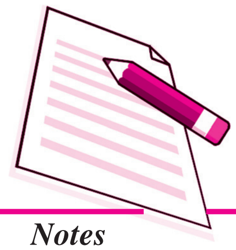
i. A statement of Affairs prepared from incomplete records provides satisfactory information.

ii. Prepration of incomplete records is scientific system.

iii. Comperative study is difficult in Single Entryf System.

21.3 ASCERTAINING PROFIT FROM INCOMPLETE RECORDS

We know that the main purpose of any business is to earn profit. Every business owner, therefore, is desirous to know whether he has earned profit or incurred loss after a certain period of time generally at the end of a year. In fact, to ascertain profit



Notes

or loss becomes all the more essential if the business happens to be a partnership firm because the partners have to share the profits of the firm at the end of the each accounting period. Then, the question arises as to how to ascertain profits when the accounting records are incomplete. The reason is that Profit and Loss Account cannot be prepared in the absence of Trial Balance. In such a situation, there are two methods used for ascertaining profits of the business. They are :

i. Net Worth Method or Statement of Affairs Method, and

ii. Conversion Method

Net Worth Method or Statement of Affairs Method

To ascertain profit, from incomplete records, it is necessary to prepare a Statement of Affairs at the end of the year and also at the beginning of the year, if not already prepared.

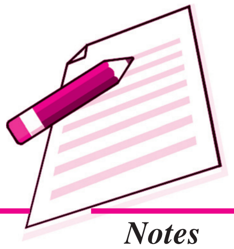
A Statement of Affairs is a statement of all assets and liabilities. The difference between the amount of the two sides is taken as capital.

Like the Balance Sheet, the Statement of Affairs has two sides - the right-hand side for assets and the left-hand side for liabilities. To prepare the statment, information has to be collected from various sources. Information about assets will be available from the Cash Book, the Personal Ledger, etc. The value of the Closing Stock will be ascertained by preparing Stock Sheets and valuing the Stock in Hand, at lower of cost and market value. If the trader has any other assets also, like furniture, machinery, etc., the value will be ascertained and included among the assets. The business is likely to have full knowledge of the amounts owing to outsiders. The difference between the total of assets and liabilities will be capital.

Capital = Total Assets - Total Liabilities

For ascertaining profit the capital in the beginning of the year must also be ascertained, if necessary, by preparing a Statement of Affairs as at the beginning of the year. If the capital at the end of the year exceeds that at the beginning, we can say that there has been a profit. If, on the other hand, the capital in the beginning was more than that at the end, there must have been a loss. However, two adjustments must be borne in mind for ascertaining profit :

i. **Adjustments for Capital Introduced :** If the proprietor broght in some additional capital during the year, it should be deducted from the capital at the end (since this increase is not due to profit but is due to fresh introduction of capital); and



ii. **Adjustement for Drawings :** The drawings of the proprietor should be added to the capital at the end. Had the drawings not been made, the capital at the close of the year would have been higher.

Formula : Formula for determining the profit is put as follows :

Profit = (Capital at the end + Drawing - Additional Capital Introduced - Capital at the beginning)

The above formula may be shown as follows in the form of Statement of Profit or Loss :

Statement of Profit or Loss

for the year ended ....

Particulars	₹
Capital at the end	....
Add : Drawings during the year	....
Less : Additional Capital introduced during the year	....
Adjusted Capital at the end	....
Less : Capital in the beginning	....
Profit or Loss for the year	....

Now the procedure explained above can be simply summarised as follows :

i. First, prepare Statement of Affairs at the beginning for calculating capital in the beginning.

ii. Then, prepare Statement of Affairs at the end in order to calculate capital at the end.

iii. Adjust the capital at the end by adding drawings, and deducting therefrom capital introduced during the year.

iv. From the adjusted capital at the end deduct capital in the beginning. This difference is either a profit or a loss.

Look at the following illustration and study how opening and closing capital are determined by preparing Statement of Affairs and then how profit is ascertained after making the necessary adjustments for additional capital and drawings.

Illustration 1

Ram maintains books on Single Entry System. He gives you the following information:

Notes

	₹
Capital on April 1, 2013	60,800
Capital on April 1, 2014	67,600
Drawings made during the Period : April 2013 to March 2014	19,200
Capital introduced on August 1, 2013	8,000

You are required to calculate profit or loss made by Ram.

Solution :

Statement of Profit or Loss
for the year ended March 31, 2014

Particulars	₹
Capital as on April 1, 2013	67,600
Add: Drawings made during the period :	
April 2013 to March 2014	19,200
	86,800
Less : Capital introduced on August 1, 2013	8,000
Adjusted Capital on April 1, 2014	78,800
Less: Capital on April 1, 2013	60,800
Profit made during the period	18,000

Illustration : 2

Rani who keeps her books on Single Entry System, tells you that her capital on 31st March, 2014 was ₹ 18,700 and her capital on 1st April, 2013 ₹ 19,200. She has withdrawn ₹ 8,420 for household purposes 8,420. She once sold her investment of ₹ 2,000 at 2% premium and brought that money into the business.

You are required to prepare a Statement of Profit or Loss.

Solution :

Statement of Profit or Loss
for the year ended March 31, 2014

Particulars	₹
Capital at the end (as given)	18,700
Add: Drawings made during the year	8,420
	27,120

Less: Capital introduced during the year : 102/100 x ₹ 2,000	2,040
Adjusted Capital at the end	25,080
Less: Capital in the beginning	19,200
Net Profit for the year	5,880

Illustration : 3

Following was the position of Arvind as on 31.3.2013 and 31.3.2014

	31.3.2013 ₹	*31.3.2014* ₹
Cash	2,000	1,800
Sundry Debtors	78,000	90,000
Stock	68,000	64,000
Plant and Machinery	1,20,000	1,60,000
Sundry Creditors	30,000	29,800
Bills Payable	-----	10,000

During 2013-14 he introduced ₹ 20,000 as new capital. He withdrew ₹ 6,000 every month for his household expenses. Ascertain his Profit for the year ending March 31, 2014.

Solution :

Statement of Affairs
as at 31st March, 2013

Liabilities	₹	*Assets*	₹
Sundry Creditors	30,000	Cash	2,000
Capital (Balancing Figure)	2,38,000	Sundry Debtors	78,000
		Stock	68,000
		Plant and Machinery	1,20,000
	2,68,000		2,68,000

Statement of Affaris
as at 31st March, 2014

Liabilities	₹	*Assets*	₹
Sundry Creditors	29,800	Cash	1,800

Notes

Bills Payable	10,000	Sundry Debtors	90,000
Capital (Balancing Figure)	2,76,000	Stock	64,000
		Plant and Machinery	1,60,000
	3,15,800		3,15,800

Statement of Profit/Loss for the year ending March 31, 2014

Particulars	₹
Capital on March 31, 2014	2,76,000
Add : Drawings during 2013-14 (₹ 6,000 x 12)	72,000
	3,48,000
Less : Fresh Capital introduced	20,000
Adjusted Capital on March 31, 2014	3,28,000
Less : Capital on March 31, 2013	2,38,000
Profit earned during 2013-14	90,000

Illustration : 4

M.S. Dhoni, a trader, does not keep proper books of account. However, he furnishes you the following particulars :

	March 31, 2013 ₹	*March 31, 2014* ₹
Cash at Bank	4,500	3,000
Cash in Hand	300	4,000
Stock-in Trade	40,000	45,000
Debtors	12,000	20,000
Office Equipment	5,000	5,000
Sundry Creditors	30,000	20,000
Furniture	4,000	4,000

During the year he introducd ₹ 6,000 as further capital and withdrew ₹ 4,000 as drawings. Write off Depreciation on furniture at 10% and on office equipment at 5%.

Prepare a statement showing the Profit or Loss made by him for the year ended 31st March, 2014.

Notes

Solution :

Statement of Affairs
as at 31.3.2013

Liabilities	₹	*Assets*	₹
Sundry creditors	30,000	Cash in hand	4,500
Capital	35,800	Cash at Bank	300
		Stock in Trade	40,000
		Debtors	12,000
		Office Equipment	5,000
		Furnitures	4,000
	65,800		65,800

Statement of Affairs
as at 31.3.2014

Liabilities	₹	*Assets*	₹
Sundry Creditors	20,000	Cash in Hand	3,000
Capital	61,000	Cash at Bank	4,000
		Stock in Trade	45,000
		Debtors	20,000
		Office Equipments	5,000
		Furniture	4,000
	81,000		81,000

Statement of Profit/Loss for the year ending March 31, 2014

Particulars		₹
Capital on March 31, 2014 before making adjustment of depreciation		61,000
Add : Drawings		4,000
		65,000
Less : Capital introduced during the year		6,000
Profit before adjustment		59,000
Less : Capital on 31 March 2013		35,800
Less : Depreciation on Office Furniture	400	23,200
Depreciation on Equipment	250	650,
Net Profit		22,550

Notes

Statement of Affairs (Revised)
as at March 31, 2014

Liabilities		₹	*Assets*		₹
Sundry Creditors		20,000	Cash at Bank		3,000
Capital (Opening)	35,800		Cash in Hand		4,000
Add: Capital introduced	6,000		Stock-in-Trade		45,000
Profit	25,000		Debtors		20,000
	64,350		Office Equipment	5,000	
Less: Drawings	4,000	60,350	*Less:* Depreciation	250	4,750
			Furniture	4,000	
			Less: Depreciation	400	3,600
		80,350			80,350

INTEXT QUESTIONS 21.2

State whether the following are True or False :

i. Capital = Total Assets + Liabilities

ii. Total Assets = Capital + Liabilities

iii. Profit = (Capital at the end + Drawing - Additional Capital Introduced - Capital at the beginning)

21.4 CONVERSION METHOD

Preparation of Final Accounts from Incomplete Records

You have learnt Net Worth Method for ascertaining business results, *i.e.,* profits. But, under this method certain vital information (*e.g.,* sales, purchases and operating expenses) is not available from incomplete records, We can get such information by adopting Conversion Method. Conversion Method means converting the accounts from incomplete records to complete records.

The steps involved in conversion are :

i. ***Prepare Cash and Bank Summary*** (if not available in proper form with both sides tallied) to ascertain the missing incormation (figures) (such as opening and closing balances of cash or bank, cash purchases/cash sales, drawings, etc.)

ii. ***Prepare Total Debtors Account*** to ascertain the missing information (*e.g.*, opening/closing balances, Bills Receivable received, Credit Sales, Payment Received from Debtors).

iii. ***Prepare Bills Receivable Account*** to ascertain the missing information (such as opening/closing blances, Bills Receivable, Bills Receivable collected, Bills Receivable endorsed).

iv. ***Prepare Total Creditors Account*** to ascertain the missing information (such as opening/closing creditors, credit purchases, Bills Payable accepted, Bills Receivable endorsed, payment made to creditors)

v. ***Prepare Bills Payable Account*** to ascertain the mising information (such as opening/closing balances, Bills Payable accepted, Bills Payable discharged).

vi. ***Prepare Opening Statement of Affairs*** to find out capital in the beginning.

vii. Now, prepare ***Trading Account, Profit and Loss Account* and *Balance Sheet*** from the various information given in the question and from the computation made as above. Before preparing the Financial Statements, Trial Balance may also be prepared to check the arithmetical accuracy.

Hints for Tracing the Missing Figures

Missing Figure	*Hints*
1. Net Credit Sales	a) Prepare Total Debtors Account b) Total Sales - Cash Sales - Sales Returns
2. Cash Sales	a) Cash and Bank Account Summary b) Total Sales - Net Credit Sales
3. Net Sales	a) Cash Sales + Credit Sales - Sales Returns b) Cost of Goods Sold + Gross Profit
4. Cost of Goods Sold	a) Opening Stock + Net Purchases + Direct Expenses - Closing Stock b) Net Sales - Gross Profit
5. Gross Profit	a) Net Sales - Cost of Goods Sold b) Net Sales x Rate of Gross Profit/100
6. Cash Purchases	a) Prepare Cash and Bank Account Summary b) Total Purchases - Net Credit Purchases

7. Net Credit Purchases	a) Prepare Total Creditors Account b) Total Purchases - Cash Purchases - Purchases Return
8. Net Purchases	a) Cash Purchases + Credit Purchases - Purchases Returns b) Cost of Goods Sold + Closing Stock - Opening Stock
9. Payment to Creditors	a) Total Creditors Account b) Cash and Bank Account Summary
10. Collection from Debtors	a) Total Debtors Account b) Cash and Bank Summary

INTEXT QUESTIONS 21.3

State Whether the following statements are true or false :

(i) Net Credit Sales = Total Sales + Cash Sales - Sales Return

(ii) Net Sales = Cost of goods sold + Gross Profit

(iii) Net Purchases = Cost of goods sold + Closing stock - Opening stock

(iv) Gross Profit = Net ales - Cost of Goods Sold.

21.5 CALCULATION OF MISSING FIGURES

The information required for preparing the Final Accounts is not directy available from incomplete records. In other words, certain figures are missing from the accounts. Hence, we need to find out such mising figures by preparing relevant accounts. The important ones are discussed below :

i. Ascertaining Total Purchases : Total purchases are calculated by combining cash and credit purchases. Cash purchases, if not given in the question, can be ascertained by balancing Cash Book. Credit purchases are calculated by preparing - (a) Total Creditors Account, or (b) Total Creditors Account and Bills Payable Account.

(a) ***Total Creditors Account :*** For ascertaining the amount of credit purchases, the Total Creditors Account should be prepared. The available information

Notes

should first be entered - opening balance on the credit side, cash paid on debit side, any discount received on debit side, and the closing balance on the debit side. Bills issued to them should also be shown on debit side. The difference between the totals of the two sides will be credit purchases.

The specimen of Total Creditors Account is given below :

Total Creditors Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Cash/Bank A/c	....	By Balance b/d	....
To Discount Received	....	By Bills Payable (Bills Payable dishonoured)	....
To Bills Payable	....	By Total Debtors A/c (Endorsed Bills Receivable dishonoured)	....
To Purchases Returns	....	By Credit Purchase (Balancing Figure)	....
To Balance c/d	....		

Illustration : 5

From the following information, you are required to calculate total purchases:

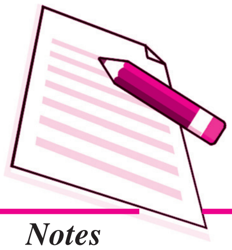
	₹
Cash Purchases	1,700
Creditors as on January 1, 2013	800
Cash Paid to Creditors	3,100
Purchases Returns	100
Creditors as on December 31, 2013	1,340

Solution :

Total Creditors Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Cash/Bank A/c	3,100	By Balance b/d	800
To Purchase Returns	100	By Purchases made during the year (Balancing Figure)	3,740
To Balance c/d	1,340		
	4,540		4,540



Notes

Total Purchases = Cash Purchases + Credit Purchases
= ₹ 1,700 + ₹ 3,740
= ₹ 5,440

(b) ***Calculation of Bills Payable Accepted :*** Just like total Creditors Account, a Bills Payable Account is drawn-up. All known figures (such as opening and closing balances of bills payable, bills payable honoured during the year) are inserted in the account and the missing figure is derived.

A format of Bills Payable Account is given below :

Bills Payable Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Cash/Bank A/c (Bills Payable discharged)	....	By Balance b/d	....
To Creditors (Bills Payable dishonoured)	....	By Total Creditors (Bills Payable accepted)	....
To Balance c/d	....		
	....		....

Illustration : 6

From the following information calculate the total purchases :

	₹
Opening balance of Bills Payable	15,000
Opening balance of creditors	18,000
Closing balance of Bills Payable	21,000
Closing balance of creditors	12,000
Cash paid to creditors during the year	90,600
Bills Payable discharged during the year	26,700
Purchases Returns	3,600
Cash Purchases	77,400

Solution :

Bills Payable Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Cash/Bank A/c	26,700	By Balance b/d	15,000
To Balance c/d	21,000	By Creditors, being bills accepted during the year (Balancing Figure)	32,700
	47,700		47,700

Total Creditors Account

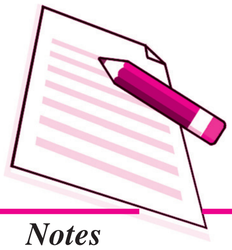
Dr. Cr.

Particulars	₹	*Particulars*	₹
To Cash/Bank A/c	90,600	By Balance b/d	18,000
To Purchases Returns	3,600	By Purchases (Bal. Fig.)	1,20,900
To Bills Payable (Fig. taken from Bills Payable A/c)	32,700		
To Balance c/d	12,000		
	1,38,900		1,38,900

Total Purchases = Cash Purchases + Creidt Purchases
= ₹ 77,400 + ₹ 1,20,900
= ₹1,98,300

ii. **Ascertaining Total Sales :** Total sales are calculated by combining cash and credit sales. Cash sales are given in the Cash Book. Credit sales are ascertained by preparing : (a) Total Debtors Account, or (b) Total Debtors Account and Bills Receivable Account.

(a) ***Total Debtors Account :*** The amount of credit sales is ascertained by preparing the Debtors Account. The available information is first entered - opening balance on the debit side, cash received on the credit side, any discount allowed or bad debt written off on the credit side and the closing balance on the credit side. Bills received from them is shown on the credit side, the amount of bills dishonoured is entered on the debit side. The difference between the totals of the two sides will be credit sales.



Notes

Total Debtors Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance b/d	....	By Cash/Bank	....
To Bills Receivable (Dishonoured)	....	By Discount Allowed	....
To Credit Sales (Balancing Figure)	....	By Sales Returns	....
		By Bad Debts	....
		By Bills Receivable	....
		By Balance c/d	....
	....		....

Illustration : 7

From the following information, calculate the total sales made during the period:

	₹
Debtors as on January 1, 2013	40,800
Cash received from Debtors	1,21,600
Sales Returns	10,800
Bad Debts	4,800
Debtors as on December 31, 2013	55,200
Cash Sales	1,13,600

Solution :

Total Debtors Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance b/d	40,800	By Cash/Bank	1,21,600
To Credit Sales	1,51,600	By Sales Returns	10,800
(Balancing Fig.)		By Bed Debts	4,800
		By Balance c/d	55,200
	1,92,400		1,92,400

Total Sales	=	Cash Sales	+	Creidt Sales
	=	₹ 1,13,600	+	₹ 1,51,600
	=	₹ 2,65,200		

(b) ***Calculation of Bills Receivable Received from Customers :*** Just like Total Debtors Account, a Bills Receivable Account is drawn-up. All known figures (such as opening and closing balances of bills receivable, bill honoured during the year, bill dishonoured, renewed during the year) are inserted in the account and the missing figure is derived as Balancing Figure.

A format of Bills Receivable Account is given below :

Bills Receivable Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance b/d	....	By Cash/Bank (B/R Collected)	....
To Total Debtors	....	By Bank (B/R discounted)	....
(Bill Receivable received)		By Banker's Discount	
		(Discounting charges)	....
		By Total Debots	
		(B/R dishonoured)	....
		By Total Creditors	
		(B/R endorsed)	....
		By Balance c/d	....
	....		....

Illustration : 8

From the following information, calculate the total sales :

	₹
Bills Receivable in the beginning	1,560
Debots in the beginning	6,160
Bills Receivable encashed during the year	4,180
Cash received from Debots	14,000
Bad Debts written off	560

Notes

Sales Returns	1,740
Bills Receivable (Dishonoured)	360
Bills Receivable at the end	1,200
Debtors at the end	5,100
Cash Sales	8,180

Solution :

Bills Receivable Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance b/d	1,560	By Cash/Bank	4,180
To Debtors, being the bills received during the year (Balancing Figure)	4,180	By Debtors (Bill Receivable dishonoured)	360
		By Balance c/d	1,200
	5,740		5,740

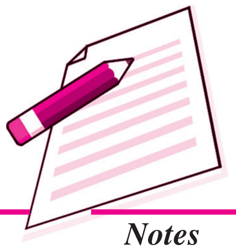
Total Debtors Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance b/d	6,160	By Cash/Bank	14,000
To Bills Receivable (Dishonoured)	360	By Bad Debts	560
To Sales (Balancing Figure)	19,060	By Sales Returns	1,740
		By Bills Receivable	4,180
		By Balance c/d	5,100
	25,580		25,580

Total Sales = Cash Sales + Creidt Sales
= ₹ 8,180 + ₹ 19,060
= ₹ 27,240

iii. Ascertaining Balance of Sundry Debtors and Sundry Creditors : If credit sales and credit purchases are given, the opening or closing balances of debtors and/or creditors can be ascertained by preparing Total Debtors Account and Total Creditors Account.



Notes

Illustration : 9

From the following information, prepare the Total Debtors Account and Total Creditors Account and find out credit sales and credit purchases :

	₹
Debtors as on 1st January	5,000
Creditors as on 1st January	4,000
Debtors as on 31st December	4,000
Creditors as on 31st December	6,000
Bills receivable received during the year	10,000
Bills Payable issued during the year	8,000
Cash received from customers	30,000
Cash returned to customers	500
Cash paid to suppliers	20,700
Discount allowed by suppliers	270
Discount allowed by customers	150
Bad Debts written off	1,200
Bad Debts recovered	300
Bills Receivable endorsed to creditors	4,000
Bills Receivable dishonoured by customers	1,000
Endorsed Bills Receivable dishonoured	500
Discounted Bills Receivable dishonoured	700
Sales Returns	600
Purchases Returns	200

Solution :

Total Debtors Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance b/d	5,000	By Cash/Bank	30,000
To Credit Sales (Balancing Fig.)	38,250	By Discount	150
To Cash Returned	500	By Bad Debts	1,200
To Bills Receivable (Dishonoured)	1,000	By Sales Returns	600
To Creditors	500	By Bills Receivable	10,000

To Bank (Discounted B/R Dishonoured)	700	By Balance c/d	4,000
	45,950		45,950

Notes

Total Creditors Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Cash/Bank	20,700	By Balance b/d	4,000
To Discount	270	By Purchases (Credit) (Balancing Figure)	34,670
To Bills Receivable (Endorsed)	4,000	By Debtors (Bills endorsed dishonoured)	500
To Purchases Returns	200		
To Bills Payable	8,000		
To Balance c/d	6,000		
	39,170		39,170

iv. Ascertaining Balancing of Bills receivable and Bills Payable : If the opening or closing balances of these items are not given, the missing figures can be ascertained by preparing Bills Receivable Account and Bills Payable Account.

Illustration : 10

From the following particulars, ascertain closing balance of Bills Receivable Account and opening balance of Bills Payable Account :

	₹
Opening balance of Bills Receivable	11,000
Closing balance of Bills Payable	8,000
Bills Payable issued	35,000
Bills Receivable encashed	46,000
Bills Receivable received	49,000
Bills Payable paid in cash	36,000
Bills Receivable dishonoured	1,000

Notes

Solution :

Bills Receivable Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance b/d	11,000	By Cash/Bank	46,000
To Sundry Debtors	49,000	By sundry Debtors	1,000
		By Balance c/d (Bal. Fig.)	13,000
	60,000		60,000

Bills Payable Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Cash/Bank	36,000	By Balance b/d (Bal. Fig.)	9,000
To Balance c/d	8,000	By Sundry Creditors	35,000
	44,000		44,000

Illustration : 11

Ashok does not maintain proper books of account. From the following particulars, prepare the Trading and Profit and Loss Account for the year ended December 31, 2014 and the Balance Sheet as on that date :

	December 31, 2013 ₹	*December 31, 2014* ₹
Debtors	9,000	12,500
Stock	4,900	6,600
Furniture	500	750
Creditors	3,000	2,250

Analysis of other transactions is as follows :

	₹
Cash collected from Debtors	30,400
Cash paid to Creditors	22,000
Salaries	6,000
Rent	750

Office Expense	900
Drawing	1,500
Additional Capital introduced	1,000
Cash Sales	750
Cash Purchases	2,500
Discount Received	350
Discount Allowed	150
Returns Inwards	500
Returns Outwards	400
Bad ebts	100

He had ₹ 2,500 as Cash Balance at the beginning of the year.

Solution :

Trading and Profit & Loss Account
for the year ended December 31, 2014

Dr. Cr.

Particulars		₹	*Particulars*		₹
To Opening Stock		4,900	By Sales :		
To Purchases :			Cash	750	
Cash	2,500		Credit (Note 3)	34,650	
Credit (Note 4)	22,000			35,400	
	24,500		*Less:* Returns	500	34,900
Less: Return	400	24,100	By Closing Stock		6,600
To Gross Profit c/d		12,500			
		41,500			41,500
To Salaries		6,000	By Gross Profit b/d		12,500
To Rent		750	By Discount Received		350
To Office Expenses		900			
To Discount Allowed		150			
To Bad Debts		100			
To Net Profit transferred to Capital A/c		4,950			
		12,850			12,850

Notes

Balance Sheet
as at December 31, 2014

Liabilities		₹	*Assets*	₹
Creditors		2,250	Cash (Note 2)	1,000
Creditors for Furniture			Debtors	12,500
(Rs. 750 - Rs. 500)	13,900		Stock	6,600
Add: Capital introduced	1,000		Furniture	750
Net Profit	4,950			
	19,850			
Less: Drawings	1,500	18,350		
		20,850		20,850

Working Notes :

1. Balance Sheet as at December 31, 2013

Liabilities	₹	*Assets*	₹
Creditors	3,000	Cash and Bank Balance	2,500
Capital (Balancing Fig.)	13,900	Debtors	9,000
		Stock	4,900
		Furniture	500
	16,900		16,900

2. Cash Book

Particulars	₹	*Particulars*	₹
To Balance b/d	2,500	By Sundry Creditors	22,000
To Sundry Debtors	30,400	By Salaries	6,000
To Capital	1,000	By Rent	750
To Cash Sales	750	By Office Expenses	900
		By Drawings	1,500
		By Purchases	2,500
		By Balance c/d	1,000
	34,650		34,650

Notes

3. Total Debtors Account

Particulars	₹	*Particulars*	₹
To Balance b/d	9,000	By Cash/Bank	30,400
To Credit Sales (Balancing Fig.)		34,650 By Discount	
150			
		By Returns Inward	500
		By Bad Debts	100
		By Balance c/d	12,500
	43,650		43,650

4. Total Creditors Account

Liabilities	₹	*Assets*	₹
To Cash/Bank	22,000	By Balance b/d	3,000
To Discount	350	By Credit Purchase	
To Return Outward	400	(Balancing Figure)	22,000
To Balance c/d	2,250		
	25,000		25,000

WHAT YOU HAVE LEARNT

- Single entry system is a system in which accounting records are not according to double entry principle of book keeping.
- Usually under this system, only personal accounts are maintained and real and nominal accounts are avoided.
- A Statement of Affairs is a statement of all assets and liabilities. The difference between the amount of the two sides is taken as capital.
- There are two methods used for ascertaining profits of the business from incomplete records are :

  i. Net Worth Method or Statement of Affairs Method

  ii. Conversion Method

- Under Statement of Affairs Method, Statement of Affairs at close and at opening are prepared to determine opening and closing capital. The capital is adjusted with respect to capital introduced and drawings made, to determine profit earned during the year.
- Under Conversion method, in complete records are converted into Double Entry System and Profit is determined.

TERMINAL EXERCISE

1. Define Single Entry System and explain its features.
2. List any three circumstances under which records may be rendered as incomplete.
3. How is profit calculated under statement of Affairs Method?
4. What do you mean by Single Entry System? Also explain the uses of Single Entry System.
5. What steps are taken to convert a set of books not maintained under Double Entry System into the same?
6. Arvind does not keep proper records of his business, he gives you the following information :

	₹
Opening Capital	2,00,000
Closing Capital	2,50,000
Drawings during the year	60,000
Capital added during the year	75,000

Calculate profit or loss for the year.

7. The following information is supplied to you by a shopkeeper :

	1 April 2013	*31 March 2014*
	₹	₹
Cash	6,000	7,000
Sundry Debtors	68,000	64,000
Stock	59,000	87,000

Furniture	15,000	13,500
Sundry Creditors	20,000	18,000
B/p	15,000	11,000

During the year the shopkeeper withdrew ₹ 2,500 per month for domestic purposes. He also borrowed from a friend at 9% a sum of ₹ 20,000 on 1st October 2013. He has not yet paid the interest. A provision of 5% on debtors for doubtful debts was to be made.

Ascertain the profit or loss made by him during the period.

ANSWERS TO INTEXT QUESTIONS

21.1 I. (i) estimated (ii) simple (iii) less

II. (i) False (ii) False (iii) True

21.2 (i) False (ii) True (iii) True

ANSWERS TO TERMINAL EXERCISE

6. Profit = ₹ 35,000

7. Profit = ₹ 35,400

320en22

22

PARTNERSHIP : AN INTRODUCTION

You have already learnt about preparation of accounts of sole proprietory form of business organisation. But, when a business expands, it goes beyond the capacity of one person to provide the capital and manage the affairs of the expanded business. A need is felt to combine his/her efforts and capital with those of another person/persons. This gives rise to the partnership form of organisation.

As far as recording of business transactions in the books of original entry, their posting to ledger and preparing financial statements are concerned there is no difference between a sole proprietor or a partnership firm. But there are certain issues which are specific to partnership firm and require separate accounting treatment. These issues are appropriation of profits of the firm, treatment of goodwill on various occasions and so on. This lesson focuses on such issues related to partnership firms.

OBJECTIVES

After going through this lesson, you will be able to :

- state the meaning and characteristics of partnership;
- explain the meaning of partnership deed and its contents;
- describe accounting treatment of specific issues related to partnership in the absence of partnership deed;
- state the meaning and preparation of capital account:
- distinguish between fluctuating and fixed capital account;

Notes

- calculate interest on capital and interest on drawings;
- state the meaning and purpose of Profit and Loss Appropriation account and its preparation;
- make adjustment for gaurantee of profit and
- make adjustments for errors made after preparing Balance Sheet.

22.1 PARTNERSHIP AND PARTNERSHIP DEED

Partnership is a form of business organisation, where two or more persons join hands to run a business. They share the profits and losses according to the agreement amongst them.

According to the Indian Partnership Act 1932,

"Partnership is relation between persons who have agreed to share profits of a business carried on by all or any one of them acting for all".

For example, one of your friends has passed class XII from National Institute of Open Schooling (NIOS) and wants to start a business. He/she approaches you to join in this venture. He/she wants you to contribute some money and participate in the business activities. Both of you if join hands, constitute a partnership.

Following are the characteristics of partnership :

- **Agreement :** A partnership is formed by an agreement. The agreement may be either oral or in writing. It defines the relationship between the persons, who agree to carry on business. It may contain the terms of sharing profit and the capital to be invested by each partner, etc. The written agreement is known as partnership deed.
- **Number of persons :** There must be at least two persons to form a partnership. The maximum number of partners in a partnership firm can be 50 according to Companies Act 2013.
- **Business :** The Partnership is formed to carry on business with a purpose of earning profits. The business should be lawful. Thus, if two or more persons agree to carry on unlawful activities, it will not be termed as partnership.
- **Sharing Profits :** The partners agree to share profits in the agreed ratio. In case of loss, all the partners have to bear it in the same agreed profit sharing ratio.

- **Mutual Agency :** Every partner is an agent of the other partners. Every partner can bind the firm and all other partners by his/her acts. Each partner will be responsible and liable for the acts of all other partners.
- **Unlimited liability :** The liability of each partner, except that of a minor, is unlimited. Their liability extends to their personal assets also. If the assets of the firm are insufficient to pay off its debts, the partners' personal property can be used to satisfy the claim of the creditors of the partnership firm.
- **Management :** All the partners have a right to mange the business. However, they may authorize one or more partners to manage the affairs of the business on their behalf.
- **Transferability of Share :** No partner can transfer his/her share to any one including his/her family member without the consent of all other partners.

Important Terms

- **Partner :** The persons who have agreed to carry on a business and share its profits and losses. They are the persons who have agreed upon the terms and conditions of partnership.
- **Firm :** Partners who carry on the business are collectively known as firm. The name under which the business is carried on is called firm name.
- **The Indian Partnership Act 1932 :** It is an Act that governs the partnership firms. In case, Partnership Deed is silent on an issue, provisions of the Indian Partnership Act, 1932 are applied.
- **Partnership deed :** Agreement forms the basis of partnership. The written form of the agreement is which is a document of partnership. It contains terms and conditions regarding the conduct of the business. It also explains relationship between the partners. This document is called partnership deed.

  Every firm can frame its own partnership deed in which the rights, duties and liabilities of the partners are stated in detail. It helps in settling the disputes arising among the partners during the general conduct of business.
- **Contents of Partnership Deed :** The partnership deed generally contains the following :

  (i) Name and address of the partnership firm;

  (ii) Nature and objectives of the business;

Notes

(iii) Name and address of each partner;

(iv) Ratio in which profits is to be shared;

(v) Capital contribution by each partner;

(vi) Rate of Interest on capital if allowed;

(vii) Salary or any other remuneration to partners, if allowed;

(viii) Rate of interest on loans and advances by a partner to the firm;

(ix) Drawings of partners and interest thereon, if any

(x) Method of valuation of goodwill and revaluation of assets and liabilities on the reconstitution of the partnership i.e. on the admission, retirement or death of a partner;

(xi) Settlement of disputes by arbitration;

(xii) Settlement of accounts at the time of retirement or death of a partner;

(xiii) Circumstances in which the firm can be dissolved;

(xiv) Settlement of accounts at the time of dissolution of a firm.

- **In the Absence of the Partnership Deed :** The partnership deed lays down the terms and conditions of partnership in regard to rights, duties and obligations of the partners. In the absence of partnership deed, there may arise a controversy on certain issues like profit sharing ratio, interest on capital, interest on drawings, interest on loan and salary of the partners. In such cases, the provisions of the Indian Partnership Act becomes applicable:

Some of the Issues are

(i) Distribution of Profit : Partners are entitled to share profits equally.

(ii) Interest on Capital : Interest on capital is not allowed.

(iii) Interest on Drawings : No interest on drawing of the partners is to be charged.

(iv) Interest on Partner's Loan : A Partner is allowed interest @ 6% per annum on the amount of loan given to the firm by him/her.

(v) Salary and Commission to Partner : A partner is not entitled to any salary or commission or any other remuneration for managing the business.

INTEXT QUESTIONS 22.1

I. *Fill in the blanks with appropriate word/words :*

(i) There must be at least .... persons to form a partnership.

(ii) A partnership is formed by ....

(iii) Agreement of partnership can be .... or ....

(iv) The written form of agreement of a partnership is called ....

(v) The liability of each partner is ....

II. *Asha and Rahul are partners in a firm . If there is no partnership deed, how will you deal with the following? Give your answer in yes or no.*

(i) Asha wants a salary of Rs.3000 per month to be paid to her. Can she claim the salary?

(ii) Rahul has advanced a loan to the firm. He claims interest @ 6% p.a. is it permissible?

(iii) Asha and Rahul contribute Rs. 50,000 each as capital. Rahul wants more profit than Asha. Is it permissible?

(iv) Asha gets contracts for the firm. She wants 2% commission on the amount of contract. Is she entitled to such commission?

(v) Rahul withdraws ₹ 500 p.m. for personal use. Asha wants interest to be charged on Rahul's drawings. Can it be charged?

22.2 CAPITAL ACCOUNT : MEANING AND PREPARATION

Partners contribute their share of capital in business. These are recorded in their respective accounts named as capital accounts. Suppose there are two partners A and B, there will be A's capital account and B's capital account. These accounts may be maintained in two ways :

(a) Fixed Capital Account

In fixed capital account, the closing balance of the capital account is same as that of opening balance except when additional capital is introduced or there is permanent withdrawal during the current accounting year. Items relating to capital account such as interest on capital, interest on drawings and share of profit etc, are recorded in

Notes

capital account. But in this case a separate account is opened for each partner to record these items. This account is known as 'current account'. A current account may show a debit or a credit balance. Format of the fixed capital account and the current account is as under :

Partner's Capital Account

Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount (₹)*	*Date*	*Particulars*	*J.F.*	*Amount (₹)*
	Bank (Permanent withdrawal of Capital)		xxx		Balance b/d (Capital contribution opening balance)		xxx
	Balance c/d (Closing balance)		xxx		Bank (Additional Capital introduced)		xxx
			xxx				xxx

Partner's Current Account

Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount (₹)*	*Date*	*Particulars*	*J.F.*	*Amount (₹)*
	Balance b/d (in case of debit opening Balance)		xxx		Balance b/d (in case of credit Opening Balance)		xxx
	Drawings A/c		xxx		Salary		xxx
	Interest on Drawings A/c		xxx		Interest on capital		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Profit and loss Appropriation (for share of profit)		xxx
	Balance c/d (in case of credit closing balance)				Balance c/d (in case of debit closing balance)		
			xxx				xxx

(b) Fluctuating Capital Account

When capital account for each partner is so maintained that in addition to the capital amount other items related to capital account such as interest on capital, drawings, net profit or net loss etc. are written in this account, it is termed as fluctuating capital. In this case there is no need to maintain a separate account for recording of these adjustments.

In the absence of any information, the capital account should be prepared by this method. The format of fluctuating capital account is as follows:

Partner's Capital Account

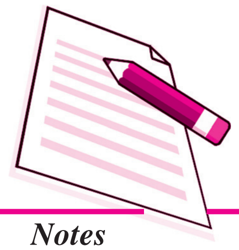
Dr. Cr.

Date	*Particulars*	*JF*	*Amount (₹)*	*Date*	*Particulars*	*JF*	*Amount (₹)*
	Balance b/d (in case of Debit opening balance)		xxx		Balance b/d (in case of Credit opening balance)		xxx
	Drawings		xxx		Bank (Additional Capital introduced) A/c		xxx
	Interest on Drawings		xxx		Salaries A/c		xxx
					Interest on Capital		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Profit and Loss Appropriation (for share of profit)		xxx
	Balance c/d (in case of credit closing balance)		xxx		Balance c/d (in case of debit closing balance)		xxx
			xxx				xxx

Illustration 1

Rohan and Monika are partners in a firm. Following information is provided as on 31 December, 2013:

	Rohan (₹)	Monika (₹)
Capital (as on 1.01.2013)	40,000	30,000
Drawings	3,000	2,000
Interest on Capital	2,000	1,500
Interest on Drawings	360	180
Share of Profit	5,000	4,000



Notes

Prepare capital account of each partner if capital is : (a) fixed, (b) fluctuating.

Solution :

(a) Fixed capital account

Capital Account

Dr. Cr.

Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)	Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)
Dec.31	Balance c/d		40,000	30,000	Jan.1	Balance b/d		40,000	30,000
			40,000	30,000				40,000	30,000

Current Account

Dr. Cr.

Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)	Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)
Dec.31	Drawings		3,000	2,000	Dec.31	Interest on capital		2,000	1,500
Dec.31	Interest on drawings		360	180	Dec.31	Profit and Loss Appropriation A/c		5,000	4,000
Dec.31	Balance c/d		3,640	3,320					
			7,000	5,500				7,000	5,500
					Jan.1	Balance b/d		3,640	3,320

(b) Fluctuating capital Account

Capital Account

Dr. Cr.

Date	Particulars	JF	Rohan (₹)	Monika (₹)	Date	Particulars	JF	Rohan (₹)	Monika (₹)
	Drawings		3,000	2,000		Balance b/d		40,000	30,000
	Interest on drawings		360	180		Interest on capital		2,000	1,500
	Balance c/d		43,640	33,320		Profit & Loss Appropriation A/c		5,000	4,000
			47,000	35,500				47,000	35,500
						Balance b/d		43,640	33,320

Distinction between Fixed and Fluctuating Capital Accounts

The main points of difference between the Fixed and Fluctuating capital accounts are as under:

S. No.	Basis of Distinction	Fixed Capital Account	Fluctuating Capital Account
1.	Number of accounts	Two separate accounts are prepared for each partner i.e. 'capital account' and 'current account'.	Only one account for each partner is prepared i.e. capital account.
2.	Adjustments	All adjustments are recorded in the current account and not in the capital account.	Adjustments are recorded directly in the capital accounts, as no current account is opened.
3.	Fixed balance	The capital account balance, normally remains, unchanged except under special circumstances.	The balance of the capital account fluctuates from period to period.
4.	Balance	Capital accounts always show a credit balance only.	The capital account can show a debit balance or a credit balance at the end of the period.

INTEXT QUESTIONS 22.2

Fill in the blanks with suitable word/words :

(i) Fixed Capital account always show .... balance only.

(ii) A .... capital account may show a debit or a credit balance.

(iii) Two separate accounts are kept for each partner, if capital is ....

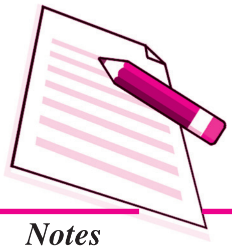
(iv) Interest on capital is shown on the .... side of the current account.

(v) Interest on drawings is shown on the .... side of the current account.

22.3 ACCOUNTING TREATMENT OF INTEREST ON CAPITAL AND INTEREST ON DRAWINGS

Interest on Capital

Let us now study about calculation of interest on capital. As you know that, interest on capital is allowed when it is provided in the Partnership Deed. If it is so provided, the



Notes

rate of interest will be as agreed upon by the partners. Interest is charged on the opening balance of the partner's capital account. When additional capital is introduced and some capital is withdrawn permanently, the interest will be calculated on the amount of the capital used in the business during a particular period. Interest is treated as an expense as it is a charge on the profits of the firm. The following journal entry will be made :

For Interest on Capital

Interest on Capital A/c Dr.
To Partner's Capital A/c (Individually)
(Crediting 'Interest on Capital' to Capital Account)

Interest can be calculated directly i.e. simple interest is to be calculated by taking the principal amount, period and rate of interest. Alternately interest can be calculated by product method i.e. by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest. The following example will illustrate both the methods of calculating interest on capital.

Illustration 2

Shilpa and Sanju are partners with a capital of ₹ 1,00,000 and ₹ 1,60,000 on January 1,2013 respectively. Shilpa introduced additional capital of ₹ 30,000 on July 1, 2013 and another ₹ 20,000 on October 31,2013. Calculate interest on capital for the year ending 2013. The rate of interest is 9% p.a.

Solution:

Interest on Capital (Shilpa):

On ₹ 1,00,000 for 12 month @ 9%	=	1,00,000 × 9/100 × 12/12
	=	₹ 9,000
On ₹ 30,000 for 6 month @ 9%	=	30,000 × 9/100 × 6/12
	=	₹ 1,350
On ₹ 20,000 for 2 month @ 9%	=	20,000 × 9/100 × 2/12
	=	₹ 300
Total interest on shilpa capital	=	₹ 9,000 + ₹ 1350 + ₹ 300
	=	₹10,650

By product method

Amount ₹	Months	Product
1,00,000	12	12,00,000
30,000	6	1,80,000
20,000	2	40,000
Total product		14,20,000

$$\text{Interest on Capital} = 14{,}20{,}000 \times \frac{9}{100} \times \frac{1}{12}$$

$$= ₹\ 10650$$

Interest on Capital (Sanju):

On ₹ 1,60,000 for 12 month @ 9% = 1,60,000 × 9/100 × 12/12
= ₹ 14,400

By product method : = 1,60,000 × 12 = 19,20,000

$$= 14{,}20{,}000 \times \frac{9}{100} \times \frac{1}{12}$$

= ₹ 14,400

22.4 INTEREST ON DRAWINGS

When a partner withdraws cash from the firm for domestic use, the withdrawal of cash is termed as drawings. If the partnership deed has a provision of charging interest on drawings, the firm may charge interest on drawings from partners. Interest on drawing is a gain for the firm. It is calculated at the agreed rate. The amount of interest on drawings will be credited to Profit and Loss Appropriation Account and will be debited to partner's capital account/current account (Individually). The journal entry will be:

Partners Capital/Current A/c Dr.
To Interest on Drawings A/c
(Charging interest on drawings to Partner's Capital account)

Calculation of interest on Drawings :

There are two methods of calculating interest on drawings

- Simple Average method
- Product method

1. SIMPLE AVERAGE METHOD

A fixed amount may be withdrawn every month/ half yearly/ annually. The interest has to be calculated for the period for which the amount has been utilised for personal purposes by the partners. The calculation of amount of interest to be charged in different situations is shown as under :

I. When Fixed Amounts are Withdrawn at Equal Time Intervals

A fixed amount is withdrawn by the partners, at equal time interval, say each month or each quarter. The calculation of total time period, in such situations will depend upon whether the money was withdrawn at the beginning of the month, middle of the month or at the end of the month.

For example, Manisha withdrew ₹ 1,000 per month from the firm for her personal use during the year ending December 31, 2013. interest is charged at the rate of 12% per annum. The calculation of average period and the interest on drawings in different situations would be as follows:

(a) When money is withdrawn at the beginning of the period

Date of Drawings	*Amount Withdrawn (₹)*	*Period (in Month)*
1 January 2013	1,000	12
1 February 2013	1,000	11
1 March 2013	1,000	10
1 April 2013	1,000	9
1 May 2013	1,000	8
1 June 2013	1,000	7
1 July 2013	1,000	6
1 August 2013	1,000	5
1September 2013	1,000	4
1 October 2013	1,000	3
1 November 2013	1,000	2
1 December 2013	1,000	1
Total	**12,000**	**78**

When money is withdrawn in the beginning of the month, the average period is calculated as under:

Notes

Average Period = Total of months/12

= 78months/12

= 6½ months

OR,

$$\text{Average Period} = \frac{\text{Max. Period of Drawing} + \text{Min. Period of Drawing}}{2}$$

$$= \frac{12 + 1}{2} = \frac{13}{2} = 6\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = 12{,}000 \times \frac{12}{100} \times \frac{6}{12}$$

$$= ₹\ 780$$

(b) When money is withdrawn at the end of the period

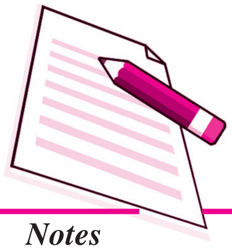
Date of drawings	*Amount Withdrawn (₹)*	*Period (in Month)*
31 January 2013	1,000	11
28/29 February 2013	1,000	10
31 March 2013	1,000	9
30April 2013	1,000	8
31 May 2013	1,000	7
30 June 2013	1,000	6
31July 2013	1,000	5
31 August 2013	1,000	4
30 September 2013	1,000	3
31 October 2013	1,000	2
30 November 2013	1,000	1
31December 2013	1,000	0
	12,000	**66**

When money is withdrawn at the end of the month, the average period is calculated as under:

Average Period = Total of months/12

= 66 months/12

= 5 ½ months



Notes

OR,

$$\text{Average Period} = \frac{\text{Max. Period of Drawing} + \text{Min. Period of Drawing}}{2}$$

$$= \frac{10+1}{2} = \frac{11}{2} = 5\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = 12{,}000 \times \frac{12}{100} \times \frac{11}{2} \times \frac{1}{2}$$

$$= ₹\ 660$$

(c) When money is withdrawn in the middle of the month:

Date of Drawings	*Amount Withdrawn (₹)*	*Period (in Month)*
15 January 2013	1,000	11.5
14 February 2013	1,000	10.5
15 March 2013	1,000	9.5
15 April 2013	1,000	8.5
15 May 2013	1,000	7.5
15 June 2013	1,000	6.5
15 July 2013	1,000	5.5
15 August 2013	1,000	4.5
15 September 2013	1,000	3.5
15 October 2013	1,000	2.5
15 November 2013	1,000	1.5
15 December 2013	1,000	0.5
Total	**12,000**	**72**

When money is withdrawn in the middle of the month, the average period is calculated as under:

Average Period = Total of months/12
= 72 months/12
= 6 months

OR,

$$\text{Average Period} = \frac{\text{Max. Period of Drawing} + \text{Min. Period of Drawing}}{2}$$

Notes

$$= \frac{11.5 + 0.5}{2} = \frac{12}{2} = 6 \text{ months}$$

$$\text{Interest on Drawings} = 12{,}000 \times \frac{12}{100} \times \frac{6}{12}$$

$$= ₹\ 720$$

(d) Withdrawal of Fixed amounts at equal time intervals (Beginning of each quarter)

If the money is withdrawn by the partners in the beginning of each quarter, the interest is calculated on total money withdrawn during the year for an average period of seven and half months.

Illustration 3

Sunny and Himanshu are partners in a firm sharing profits and losses equally. During financial year 2013, Sunny withdrew ₹ 20,000 quarterly at the beginning of each quarter. If interest is to be charged on drawings @ 8% per annum, calculate the amount of interest to be charged at the end of the year.

Solution :

Statement Showing Calculation of Interest on Drawings

Date	*Amount (₹)*	*Time Period*	*Interest (₹)*
Jan. 1, 2013	20,000	12 months	$20{,}000 \times \frac{8}{100} \times \frac{12}{12}$ = ₹ 1,600
April 1, 2013	20,000	9 months	$20{,}000 \times \frac{9}{12} \times \frac{8}{100}$ = ₹ 1,200
July 1, 2013	20,000	6 months	$20{,}000 \times \frac{6}{12} \times \frac{8}{100}$ = ₹ 800
Oct. 1, 2013	20,000	3 months	$20{,}000 \times \frac{3}{12} \times \frac{8}{100}$ = ₹ 400
Total	80,000		= ₹ 4,000

Alternatively, the interest can be calculated on the total sum withdrawn during the accounting year, which is ₹ 80,000 in this case, for a period of 7½ months

$$\frac{(12+9+6+3)}{4} = 7\frac{1}{2} = \frac{15}{2}$$

Thus,

$$\text{Interest on Drawings} = \text{Total sum Withdrawn} \times \text{Rate} \times 7\frac{1}{2} \times \frac{1}{12}$$

$$= 80{,}000 \times \frac{8}{100} \times \frac{15}{2} \times \frac{1}{12}$$

$$= ₹\ 4{,}000.$$

(e) When fixed amount is withdrawn at the end of each quarter

When the amounts are withdrawn at the end of each quarter the amount of interest is calculated on total drawings for a period of four and a half months.

In the previous illustration, if the money is withdrawn at the end of each quarter, the average period for calculation of interest will be taken as four and half months. The calculation of interest can be shown as follows:

Statement of Calculation of Interest on Drawings

Date	*Amount (₹)*	*Time Period*	*Interest (₹)*
March 31	20,000	9 months	$20{,}000 \times \frac{9}{12} \times \frac{8}{100}$ = ₹ 1,200
June 30	20,000	6 months	$20{,}000 \times \frac{6}{12} \times \frac{8}{100}$ = ₹ 800
September 30	20,000	3 months	$20{,}000 \times \frac{3}{12} \times \frac{8}{100}$ = ₹ 400
December 31	20,000	0 months	₹ 0
Total	**80,000**	**18 months**	**= ₹ 2,400**

Alternatively, the interest on ₹ 80,000 for a period 4½ months is calculated as :

$$\frac{(9+6+3+0)}{4} = 4\frac{1}{2} = \frac{9}{2}$$

$$\text{Interest on Drawings} = 80{,}000 \times \frac{8}{100} \times \frac{9}{12} \times \frac{1}{12}$$

$$= ₹\ 2{,}400$$

(f) When fixed amount is withdrawn at the middle of each quarter

When the amounts are withdrawn at the middle of each quarter the amount of interest is calculated on total drawings for a period of six months.

(g) When no specific period of drawing is given in the question

If no time period is mentioned in the question for which the drawings will be charged for a period of on an average of six months.

PRODUCT METHOD

When different amounts are withdrawn at different intervals

Under the product method, for each withdrawal, the money withdrawn is multiplied by the period for which it remained withdrawn during the financial year. The period is calculated from the date of the withdrawal to the last day of the accounting year. The products so calculated are totalled and interest for 1 month at the specified rate is found out on the total of the products. The calculation of interest can be explained with the help of the preceding illustration.

Statement showing calculation of interest on Drawings

Date	*Amount* (₹)	*Time Period*	*Product* (₹)
Jan. 1, 2013	20,000	12 months	2,40,000
April 1, 2013	20,000	9 months	1,80,000
July 1, 2013	20,000	6 months	1,20,000
Oct. 1, 2013	20,000	3 months	60,000
Total	**80,000**		**6,00,000**

Interest on drawing = Total of Product x interest rate x1/12

= ₹6,00,000 × 8/100 × 1/12

= ₹ 4,000

INTEXT QUESTIONS 22.3

I. Fill in the blanks with appropriate word/words :

(i) Interest on capital is .... in partner's capital account.

(ii) Interest on drawings is .... in partner's capital account.

(iii) Interest is charged on the .... of the partner's capital account.

(iv) When money is withdrawn in the begining of the each month, the average period is .... for charging interest.

Notes

II. Reema and Anish are partners with a capital of ₹50,000 and ₹80,000 on April 2013, respectively. Reema introduced additional capital of ₹50,000 on 1st Jan 2014. Calculate interest on capital @10 p.a. on March 31, 2014.

III. Ashu withdrew ₹2000 p.m. from business for personal use at the end of every month during the year. Calculate interest on Drawing @10 p.a.

22.5 PROFIT AND LOSS APPROPRIATION ACCOUNT: MEANING AND PREPARATION

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. The profit of the firm has to be distributed amongst the partners in their respective profit sharing ratio. But before its distribution it needs to be adjusted. All Adjustments like partner's salary, partner's commission, interest on capital, interest on drawings etc. are made in this account. These adjustments will reduce the amount of profit for distribution. This adjusted profit will be distributed amongst the partners in their profit sharing ratio. To prepare it, at first, the balance of Profit and Loss Account is transferred to this account. The journal entries for the preparation of Profit and Loss Appropriation Account are given below:

1. For transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation Account

(a) In case of Net Profit :

Profit and Loss A/c Dr.

To Profit and Loss Appropriation A/c

(Net Profit transferred to Profit and Loss Appropriation A/c)

(b) In case of Net Loss :

Profit and Loss Appropriation A/c Dr.

To Profit and Loss A/c

(Net Loss transferred to Profit and Loss Appropriation A/c)

Notes

2. *For Interest on Capital*

For transferring on Interest on Capital :

Profit and Loss Appropriation A/c Dr.

To Interest on Capital A/c

(Interest on capital transferred to Profit & Loss Appropriation A/c)

3. *For Interest on Drawings*

For transferring Interest on Drawings :

Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c

(Interest on drawing transferred to Profit & Loss Appropriation A/c)

4. *For Partner's Salary*

For transfer of partner's Salary

Profit and Loss Appropriation A/c Dr.

To Salary A/c

(Salary transferred to profit & Loss Appropriation A/c)

5. *For Partner's Commission*

For transferring commission

Profit and Loss Appropriation A/c Dr.

To Commission A/c

(Commission transferred to Profit and Loss Appropriation A/c)

6. *For Transfer of agreed amount to General Reserve*

Profit and Loss Appropriation A/c Dr.

To General Reserve A/c

(Transfer to General Reserve)

7. *For share of Profit or Loss appropriation*

(a) If Profit

Profit and Loss Appropriation A/c Dr.

To Partner's Capital/Current A/c

(Profit transferred to capital/current A/c)

(b) If Loss

Partner's Capital/ Current A/c Dr.

To Profit and Loss Appropriation A/c

(Loss transferred to capital/current A/c)

The format of Profit and Loss Appropriation Account is given as follows.

Notes

Profit and Loss Appropriation Account

for the year ended on ....

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Profit and Loss A/c	xxx	Profit and Loss A/c	xxx
(if there is loss)		(if there is profit)	
Interest on Partners'		Interest on Drawings	xxx
Capital's A/c	xxx	Partner's capital A/c	xxx
Partners' Salary A/c	xxx	(distribution of loss)	
Partners' Commission A/c	xxx		
Interest on Partners' Loan A/c	xxx		
General Reserve	xxx		
Partners' Capital A/c	xxx		
(distribution of profit)			
	xxx		**xxx**

Illustration 4

Monika and Krishan are partners with a capital of ₹ 80,000 and ₹ 1,00,000 respectively. They agree on the followings:

(a) To share profit equally.

(b) Interest allowed on capital @ 9% p.a.

(c) Interest charged on drawing @ 6% p.a.

(d) Salary to be paid to Krishan @ ₹ 600 per month.

(e) Monika withdrew ₹ 8,000 and Krishan ₹ 6,000 during the year.

Profit for the year ending December 31, 2013 was ₹ 56,000. You are required to prepare Profit and Loss Appropriation account.

Solution :

Working Notes:

First you should calculate the interest on capital and the interest on drawings.

Interest on Capital

Monika = ₹ 80,000 × 9/100
= ₹ 7,200

Krishan = ₹ 1,00,000 × 9/100
= ₹ 9,000

Interest on Drawings

Monika's Drawings = ₹ 8,000

Interest = ₹ 8,000 × 6/100
= ₹ 0.480

Krishan's Drawings = ₹ 6,000

Interest = ₹ 6,000 × 6/100
= ₹ 360

Profit and Loss Appropriation Account

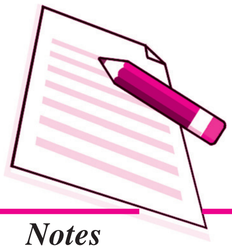
Dr. Cr.

Particulars		*Amount (₹)*	*Particulars*		*Amount (₹)*
Interest on Capital's A/c :			Profit and Loss		56,000
Monika	7,200		Interest on Drawings :		
Krishan	9,000	16,200	Monika	480	
Krishan Salary		7,200	Krishan	360	840
Profit transferred to					
Partners' Capital A/c :					
Monika	16,720				
Krishan	16,720	33,440			
		56,840			56,840

INTEXT QUESTIONS 22.4

(i) List the items which usually appear on the debit side of Profit and loss Appropriation Account.

(ii) If, balance of Profit and Loss Account is debit, what entry will be recorded for transferring the amount to Profit and Loss Appropriation account?



Notes

(iii) When interest on drawings is to be transferred to Profit and Loss Appropriation account, what journal entry is to be recorded in the books?

22.6 GUARANTEE OF PROFIT

Sometimes, a partner is admitted in the firm on guarantee in respect of his minimum share of profit from the business. Such a gurantee can be given even to an existing partner also. Such a guarantee to the incoming partner is given either by :

(a) the firm *i.e.* by all the old partners in an agreed ratio, or

(b) some of the old partners or any one of the old partners

When all the partners guarantee that one of the partners shall be given a minimum amount of profit, we should calculate the following two amounts separately:

i. Share of profit of the guaranted partner as per profit sharing ratio, and

ii. Minimum guaranteed amount of profit of the guanteed partner.

The higher of the above two is to be given to that partner. The balance of profit (total profit minus profit given to the guaranteed partner) is to be shared by the remaining partners in their respective profit -sharing ratio.

When the new partner's share of profit is more than the guaranteed amount, his actual share of profit is given to him instead of the guaranteed amount of profit.

Illustration 5 (Guarantee given by the firm to a partner)

X and Y share profits & Losses in the ratio of 2 : 1 as from 1st April, 2013, they admited Z as a partner who was to have one-tenth share of profit with a guaranteed amount of ₹1,60,000. X and Y continue to share profits as before. The profit for the year ended 31st March 2014 amounted to ₹ 10,00,000.

Prepare Profit & Loss Appropriation A/c for the year ended March 31, 2014.

Solution :

Profit & Loss Appropriation Account
for the year ended 31st March, 2014

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Partner's Capital A/cs (Note)		By Profit & Loss A/c	
X 5,60,000		- Profit for the year	10,00,000

Y	2,80,000			
Z	1,60,000	10,00,000		
		10,00,000		10,00,000

Note : Z will get higher of the following:

(i) Share of profit as per profit-sharing ratio,

i.e., $\frac{1}{10}$ of ₹ 10,00,000 = ₹ 1,00,000

(ii) Minimum guaranteed profit, i.e., ₹ 1,60,000

Therefore, from ₹ 10,00,000; ₹ 1,60,000 is to be given (being higher) to Z first and balance of ₹ 8,40,000 (₹ 10,00,000 - ₹ 1,60,000) will be shared by X and Y in the ratio of 2 : 1.

In effect :

X will get ₹ 5,60,000 $\left(\frac{2}{3} \text{ of Rs.}8{,}40{,}000\right)$; Y will get ₹ 2,80,000 $\left(\frac{1}{3} \text{ of Rs.}8{,}40{,}000\right)$ and Z will get ₹ 1,60,000 (guaranteed profit).

When the guarantee is given not by all the partners or the firm but by any one of the partner or some of the partners then the difference between the guaranteed amount and his share of profit shall be borne by the partner or partners who have given the guarantee either in the old profit sharing ratio or in any other agreed ratio as the case may be.

Illustration : 6 (Guarantee of Profits by one partner)

A, B and C are partners in a firm. Their profit sharing ratio is 5 : 3 : 2. However, C is guaranteed a minimum amount of ₹ 50,000 as share of profit every year. Any deficiency arising on that amount shall be met by B. The profits for the two years ended 31st March, 2010 and 2011 were ₹ 2,00,000 and ₹ 3,00,000 respectively. Prepare the Profit & Loss Appropriation A/c for the two years.

Solution :

Profit and Loss Appropriation Account

for the year ended 31st March 2010

Dr. Cr.

Particulars	*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to :		By Profit and Loss A/c	2,00,000
A's Capital A/c (5/10)	1,00,000	(Net Profit)	

B's Capital A/c (3/10)	60,000			
Less: Transferred to C	10,000	50,000		
C's Capital A/c (2/10)	40,000			
Add: Transferred from B	10,000	50,000		
		2,00,000		2,00,000

Profit and Loss Appropriation Account
for the year ended 31st March 2011

Dr. Cr.

Particulars	*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to :		By Profit and Loss A/c	3,00,000
A's Capital A/c (5/10)	1,50,000	(Net Profit)	
B's Capital A/c (3/10)	90,000		
C's Capital A/c (2/10)	60,000		
	3,00,000		3,00,000

Note : C's share of profits is more than the guaranteed amount, so there is no need for any adjustment.

Illustration : 7 (Minimum Profit Guaranteed to a partner by another Partner of the Firm)

P, Q and R entered into partnership on 1st April 2010 to share profits and losses in the ratio of 5 : 3 : 2. P, guarnateed that R's share of profits, after charging interest on capital @ 5% p.a., would not be less than ₹ 30,000 in any year.

The capital was provided as follows : A- ₹ 3,20,000; B- ₹ 2,00,000 and C- ₹ 1,60,000. The profits for the year ended 31st March 2011 amounted to ₹ 1,59,000 before providing for interest on capital.

Prepare Profit and Loss Appropriation A/c for the year ended 31st March 2011.

Solution :

Profit and Loss Appropriation Account
(for the year ended 31st March 2011)

Dr. Cr.

Particulars		*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Interest on Capitals :			By Profit and Loss A/c	1,59,000
P	16,000		(Net Profit)	

Notes

Q 10,000			
R 8,000	34,000		
To Share of Profit :		By Balance b/d	1,25,000
P : 5/10 of ₹ 1,25000 62,500			
Less: Adjustment for			
guarantee 5,000	57,500		
Q 3/10 of ₹ 1,25,000	37,500		
R 2/10 of ₹ 1,25,000 25,000			
Add: Adjustment for			
guarantee 5,000	30,000		
	1,25,000		1,25,000

Illustration 8

M and N were in partnership sharing profits and losses in the ratio of 3 : 2. In appreciation of the services of O, their manager who was in receipt of a salary of ₹ 24,000 and a commission of 5% of net profit after charging salary and commission. They took him into partnership from 1st April, 2010 giving him 1/8th share of profits. The agreement provided that any excess over his former remuneration to which O becomes entitled will be borne by M and N in the ratio of 2 : 3. The profits for the year ended 31st March, 2011 amounted to ₹ 4,44,000.

Prepare the Profit and Loss Appropriation Account, for the year ended on March 31, 2011.

Solution :

Profit and Loss Appropriation Account

for the year ended 31st March, 2011

Dr. Cr.

Particulars	*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to		By Profit as per Profit	
M's Capital A/c 2,40,000		and Loss A/c	4,44,000
Less: Trfd. to C 4,600	2,35,400		
N's Capital A/c 1,60,000			
Less: Trfd. A/c 6,900	1,53,100		
O's Capital A/c 44,000			
Add: From A 4,600			
From B 6,900	55,500		
	4,44,000		4,44,000

Working Notes :

				₹
1.	Profit for the year			
	O's Share as partner (1/8 x ₹ 4,44,000)	=		55,500
	Less: Amount payable to O as employee :			
	Salary	=	24,000	
	Commission $\frac{5}{105}$ (₹ 4,44,000 - ₹ 24,000)	=	20,000	44,000
	Deficiency			11,500

Deficiency chargeable to M and N in the ratio 2 : 3

∴ A to bear = 11,500 x 2/5 = 4,600

B to bear = 11,500 x 3/5 = 6,900

2. Profit for the year available to M and N (₹ 4,44,000 - C's share as Manager ₹ 44,000) = ₹ 4,00,000

A's Share = ₹ 4,00,000 x 3/5 = ₹ 2,40,000 - Share in deficiency

B's Share = ₹ 4,00,000 x 2/5 = ₹ 1,60,000 - Share in deficiency

Illustration 9 (Minimum earning Guaranteed by a Partner to the Firm and Minimum Profit Guaranteed by the Firm to a Partner)

Three Chartered Accountants A, B and C form a partnership, sharing profits and losses in the ratio of 3 : 2 : 1 subject to the following conditions:

i. C's share of profits is guaranteed to be not less than ₹ 3,00,000 p.a.

ii. B gives a guarantee to the effect that the gross fee earned by him for the firm shall not be less than the average gross fee earned by him during the preceding five years, when he was carrying on the profession alone (the average of which work out at ₹ 5,00,000)

The profits for the first year (year ended 31st March, 2011) of the partnership are ₹ 15,00,000. The gross fees earned by B for the firm are ₹ 3,20,000.

You are required to show the Profit and Loss Appropriation Account (after giving effect to the above).

Notes

Solution :

Profit and Loss Appropriation Account
for the year ended 31st March, 2011

Dr. Cr.

Particulars		*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to :			By Profit and Loss A/c	
A's Capital A/c	8,40,000		-Net Profit	15,00,000
Less: Deficiency of			By B's Capital A/c	1,80,000
C transferred	12,000	8,28,000	(W.N. 1)	
(W.N. 2)				
B's Capital A/c	5,60,000			
Less: Deficiency of				
C transferred	8,000	5,52,000		
(W.N. 2)				
C's Capital A/c	2,80,000			
Add: From A	12,000			
B	8,000	3,00,000		
		16,80,000		16,80,000

Working Notes :

		₹
1.	Profits for the first year of partnership	15,00,000
	Add: Difference between the guaranteed fees to be earned by B and actual fees earned (₹ 5,00,000 - ₹ 3,20,000)	1,80,000
	Projected net profit of the firm	16,80,000

A's Share = ₹ 16,80,000 x 3/6 = ₹ 8,40,000

B's Share = ₹ 16,80,000 x 2/6 = ₹ 5,60,000

C's Share = ₹ 16,80,000 x 1/6 = ₹. 2,80,000

2. C was guaranteed a minimum sum of ₹ 3,00,000. Hence, the deficiency of ₹ 20,000 will be borne by A and B in the ratio of 3 : 2 as follows :

A - ₹ 20,000 x 3/5 = ₹ 12,000; B - ₹ 20,000 x 2/5 = ₹ 8,000

Thus, A's Share of Profit = ₹ 8,40,000 - ₹ 12,000 = ₹. 8,28,000

B's Share of Profit = ₹ 5,60,000 - ₹ 8,000 = ₹ 5,52,000

C's Share of Profit = ₹ 2,80,000 + ₹ 12,000 (A) + ₹ 8,000 (B)

Notes

In case, a partner has been guaranteed a minimum profit by the firm and also by a partner, first the guarantee given by a partner's shall be effected. This will be clear from the following illustration.

Illustration 10 (Guarantee by the Firm as well as by Partners)

P, Q, R and S are partners sharing profits and losses in the ratio of 4:3:2:1. Their capitals as on 1st April, 2012 were ₹ 3,00,000; ₹ 2,50,000; ₹ 1,50,000 and ₹ 1,00,000 respectively.

S's share of profits excluding interest on capital has been guaranteed by the firm to be not less than ₹ 2,50,000. R's share of profits including interest on capital and salary guaranteed by P is not less than ₹ 2,60,000.

The profits for the year ended 31st March, 2014 were ₹ 9,00,000 before interest on capital @ 10% and salary to R @ ₹ 10,000 per month.

Prepare the Profit and Loss Appropriation Account for the year ended on March 31, 2014.

Solution :

Profit and Loss Appropriation Account
for the year ended 31st March, 2014

Dr. Cr.

Particulars		*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Interest on Capitals :			By Profit and Loss A/c	
P (₹ 3,00,000 x 10/100)	30,000		- Profit	9,00,000
Q (₹ 2,50,000 x 10/100)	25,000			
R (₹ 1,50,000 x 10/100)	15,000			
S (₹ 1,00,000 x 10/100)	10,000	80,000		
To R's Salary (₹ 10,000 x 12)		1,20,000		
To Share of Profit :				
(₹ 9,00,000 - ₹ 80,000 - ₹ 1,20,000) = ₹ 7,00,000				
P:4/10 of ₹ 7,00,000 =	2,80,000			
Less: Firms Deficiency borne (W.N.1) (₹ 1,80,000 x 4/9)	80,000			
Deficiency borne	25,000	1,75,000		
Q:3/10 of ₹ 7,00,000 =	2,10,000			

Notes

Less: Firm's Deficiency				
(₹1,80,000 x 3/9)	60,000	1,50,000		
R:2/10 of ₹ 7,00,000 =	1,40,000			
Less: Firm's Deficiency				
(₹ 1,80,000 x 2/9)	40,000			
	1,00,000			
Add: Deficiency recovered				
from P (W.N. 2)	25,000	1,25,000		
S:1/10 of ₹ 7,00,000 =	70,000			
Add: Deficiency recovered				
from P, Q and R	1,80,000	2,50,000		
		9,00,000		9,00,000

Working Notes :

1. Calculation of firm's deficiency :

	₹
S's share of profit excluding interest on Capital has been guaranteed by firm	2,50,000
Less: S's share of profit (₹ 7,00,000 x 1/10)	70,000
Firm's deficiency borne by P, Q and R	1,80,000

2. Calculation fo deficiency recovered by R from P :-

R's share of profits (₹ 7,00,000 x 2/10)		1,40,000
Less: R's share in firm's deficiency (₹ 1,80,000 x 2/9)		40,000
		1,00,000
Add : Interest on Capital	15,000	
Salary	1,20,000	1,35,000
		2,35,000
Deficiency recovered from P (Balancing Figure)		25,000
R's share of profits including interest on capital and salary is guaranteed by P		2,60,000

PAST ADJUSTMENT (Relating To Interest on Capital, Interest on Drawings, Salary and Change in Profit Sharing Ratio)

Sometimes, after closing the accounts of the partnership firm at the end of the financial year, it is discovered that there had been some errors or omissions in the accounts. In such cases, instead of altering the old accounts and the signed Balance Sheet an adjustment entry for such errors or omissions is made at the beginning of the next year. Usually the following types of adjustments are made:-

Notes

i. Omission of Interest on Capital or on Drawings.

ii. Distribution of Profit and Loss among the partners in the wrong proportion.

iii. Altering of Profit sharing ratio with effect from some past data i.e. respectively partner.

iv. Omission of salary or commission payable to a partner.

Illustration 11

P, Q and R are partners sharing profits and losses in the ratio of 3 : 2 : 1. After the final accounts have been prepared, it was discovered that interest on drawings had not been taken into consideration. The Interest on drawing of partners amounted to P - ₹ 500; Q - ₹ 360 and R - ₹ 200. Give the necessary adjusting journal entry.

Solution :

Interest charged on P's drawings	=	₹ 500
Interest charged on Q's drawings	=	₹ 360
Interest charged on R's drawings	=	₹ 200
Total interest to be charged from partners		₹ 1060

This amount of ₹ 1060 is an item of income for the firm but this has not been recorded on the credit side of P & L A/c of the previous year. As such the profit of the previous year will now be increased by this amount. Hence, this profit ₹ 1060 will be shared by the partners in their profit sharing ratio of 3:2:1 which amount to P ₹ 265, Q Rs. 177 and R ₹ 88.

Table Showing Adjustment

		P ₹	Q ₹	R ₹	Total ₹
Interest on Drawing	(Dr.)	500	360	200	1,060
Division of ₹ 530 in 3:2:1	(Cr.)	530	354	176	1,060
Difference		Cr. 30	Dr. 6	Dr. 24	----

Hence, the adjusting entry will be :

Journal Entry

	Particulars		Dr. ₹	Cr. ₹
	Q's Capital A/c	Dr.	6	

Notes

	R's Capital A/c Dr.	24	
	To P's Capital A/c		30
	(Adjustment in respect of interest on drawing omitted in previous year's accounts)		

Illustration 12

A, B and C are partners sharing profits and losses in the ratio of 3 : 2 : 1. After the final accounts have been prepared, it was discovered that interest on drawings @5% p.a. had not been taken into consideration. The drawings of the partners were : A - ₹ 75,000; B - ₹ 63,000; C - ₹ 60,000. Give the necessary adjusting journal entry.

Solutions :

Calculation of Interest on Drawings :

Since date of drawings are not given, interest will be charged for 6 months.

A : 5% on ₹ 75,000 for 6 months	=	1875
B : 5% on ₹ 63,000 for 6 months	=	1575
C : 5% on ₹ 60,000 for 6 months	=	1500
Total		4,950

Table Showing Adjustment

		A ₹	*B* ₹	*C* ₹	*Total* ₹
Interest on Drawings	(Dr.)	1,875	1,575	1,500	4,950
Division of Rs. 4,950 in 3:2:1	(Cr.)	2,475	1,650	825	4,950
		Cr. 600	Cr. 75	Dr. 675	-----

Journal Entry

Particulars	*Dr.* ₹	*Cr.* ₹
C's Capital A/c Dr.	675	
To A's Capital		600
To B's Capital		75
(Adjustment of omission of interest on drawings)		

Illustration 13

M and N were partners in a firm sharing profits in 3 : 2 ratio. Their respective fixed capitals were ₹ 2,00,000 and ₹ 3,00,000. The partnership deed provided the following:

i. Interest on capital @ 10% p.a.

ii. Interest on drawing @ 12% p.a.

During the year ended 31-3-2014, M's drawings were ₹. 1,000 per month drawn at the end of every month and N's drawings were ₹. 2,000 per month drawn in the beginning of the every month. After the preparation of final accounts for the year ended 31-3-2014 it was discovered that interest on M's drawings was not taken into consideration.

Calculate interest on M's drawings and give necessary adjusting entry for the same.

Solution :

Calculation of Interest on N's Drawings :

Total drawings for the year = ₹ 1,000 x 12 = ₹ 12,000

When equal amount is withdrawn at the end of every month, interest is calculated for an average period of months :

Interest on Drawings = $12{,}000 \times \frac{12}{100} \times \frac{5.5}{12}$ = ₹ 660

Table Showing Adjustment

		M ₹	*N* ₹	*Total* ₹
Interest on Drawings	(Dr.)	660		660
Division of Rs. 660 in 3 : 2	(Cr.)	396	264	660
	Difference	Dr. 264	Cr. 264	----

Adjustment Entry

	Particulars	*Dr.* ₹	*Cr.* ₹
	M's Current A/c Dr.	264	
	To N's Current A/c		264
	(Adjustment of omission of interest on drawings)		

Notes

Illustration : 14

X, Y and Z are partners sharing profits in the ratio of 5 : 4 : 3. Their capitals on 1st April 2013 were ₹ 5,00,000; ₹. 4,00,000 and ₹ 2,00,000 respectively. After closing the accounts on 31st March 2014 it was found out that according to the partnership agreement interest at 10% p.a. on partners' capital's a salary of ₹ 60,000 per year to B and a salary of ₹ 70,000 per year to C was not provided before distribution of profit. It was agreed among the partners to make the adjustment entry at the begining of the next year rather than to alter the Balance Sheet. Pass the necessary journal entry assuming that capitals are not fixed.

Solution :

Table Showing Adjustments

	X ₹	*Y* ₹	*Z* ₹	*Total* ₹
Interest on Capital @10% p.a.	50,000	40,000	20,000	1,10,000
Salaries	---	60,000	70,000	1,30,000
Total Amt. Payable (Cr.)	50,000	1,00,000	90,000	2,40,000
Division of firm's loss of ₹ 2,40,000 in 5 : 4 : 3 (Dr.)	1,00,000	80,000	60,000	2,40,000
	(Dr.) 50,000	(Cr.) 20,000	(Cr.) 30,000	-------

Journal Entry

Date	*Particulars*	*Dr. ₹*	*Cr. ₹*
Mar. 31	X's Capital A/c Dr.	50,000	
	To Y's Capital A/c		20,000
	To Z's Capital A/c		30,000
	(The adjustment for the omission of interest on capital and salary)		

Illustration 15

Ram and Rahim were partners in a firm sharing profits in the ratio of 7 : 5. Their respective fixed capitals were Ram ₹ 10,00,000 and Rahim ₹ 7,00,000. The partnership deed provided for the following :

i. Interest on Capital @ 12% p.a.

ii. Ram's Salary ₹ 72,000 per year and Rahim's salary ₹ 5,000 per month.

The profit for the year ended 31-3-2014 was ₹ 5,04,000 which was distributed equally, without providing for the above. Pass the adjustment entry.

Solution :

Statement of Adjustments

		Ram ₹	Rahim ₹	Total ₹
Interest on Capital	(Cr.)	1,20,000	84,000	2,04,000
Salary	(Cr.)	72,000	60,000	1,32,000
Profit remaining after allowing interest on capital and salary will be ₹ 5,04,000 - ₹ 2,04,000 - ₹ 1,32,000 = ₹ 1,68,000. It will be divided in their profit sharing ratio, *i.e.,* 7 : 5		98,000	70,000	1,68,000
Net amount which should have been received	(Cr.)	2,90,000	2,14,000	5,04,000
Less: Profit already distributed equally	(Dr.)	2,52,000	2,52,000	5,04,000
Net Effect		(Cr.) 38,000	(Dr.) 38,000	

Adjustment Entry

Date	Particulars		Dr. ₹	Cr. ₹
2014	Rahim's Current A/c	Dr.	38,000	
Apr. 1	To Ram's Current A/c			38,000
	(Adjustment for interest on capital, salary and wrongly distribution of profit)			

Illustration 16 (Cancellation of excessive interest)

P, Q and R are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capital were ₹ 5,00,000; ₹ 10,00,000 and ₹ 20,00,000 respectively. For the year 2013 interest on capital was credited to them @12% instead of 10%. Pass the necessary adjustment entry.

Solution :

Table Showing Adjustment

		P	Q	R	Total
Excess interest	(Dr.)	10,000	20,000	40,000	70,000
Division in 2:3:5 ratio	(Cr.)	14,000	21,000	35,000	70,000
Net Effect		(Cr.) 4,000	(Cr.) 1,000	(Dr.) 5,000	----

Notes

Adjustment Entry

Date		₹	₹
Jan. 1	R's Current A/c Dr.	5,000	
	To P's Current A/c		4,000
	To Q's Current A/c		1,000
	(Interest excessive charged, now rectified)		

Illustration 17 (Rectification of Interest on Capital charged less)

Amar, Akbar and Anthony are partners in a firm sharing profits and losses in the ratio of 2 : 1 : 2. Their fixed capitals were ₹ 30,00,000; ₹ 10,00,000 and ₹ 20,00,000 respectively. Interest on capital for the year 2013 was credited to them @ 9% p.a. instead of 10% p.a. The profit for the year before charging interest was ₹ 25,00,000. Prepare necessary adjustment entry.

Solution :

Table Showing Adjustment

	Amar ₹	Akbar ₹	Anthony ₹	Total ₹
Less interest credited (Cr.)	30,000	10,000	20,000	60,000
Division in 2:1:2 ratio (Dr.)	24,000	12,000	24,000	60,000
Net Effect	(Cr.) 6,000	(Dr.) 2,000	(Dr.) 4,000	

Adjustment

2014		₹	₹
Jan. 1	Akbar's Current A/c Dr.	2,000	
	Anthony's Current A/c Dr.	4,000	
	To Amar's Current A/c		6,000
	(Interest less charged on capital, now rectified)		

Illustration 18

A, B and C are partners in a firm on 1st April 2013 their capital accounts stood at ₹ 3,00,000 ₹ 1,50,000 and ₹ 1,50,000 respectively.

As per the provisions of the deed :

i. C was to be allowed a remuneration of ₹ 30,000 p.a.

ii. Interest at 5% p.a. was to be provided on capital.

iii. Profits were to be divided in the ratio of 2 : 2 : 1.

Ignoring the above terms, net profit of ₹ 1,80,000 for the year ended 31st March 2014 was divided among the three partners equally.

Pass an adjustment entry to rectify the error. Show the workings clearly.

Solution :

Statement of Adjustment

	A ₹	B ₹	C ₹	Total ₹
Remuneration to C (Cr.)			30,000	30,000
Interest on Capital (Cr.)	15,000	7,500	7,500	30,000
Profit remaining after allowing remuneration and interest on capital will be ₹ 1,80,000 - ₹ 30,000 - ₹ 30,000 = ₹ 1,20,000. It will be divided in their profit sharing ratio, *i.e.*, 2 : 2 : 1.	48,000	48,000	24,000	1,20,000
Net amount which should have been received (Cr.)	63,000	55,500	61,500	1,80,000
Less : Profit already distributed equally (Dr.)	60,000	60,000	60,000	1,80,000
Net effect	(Cr.) 3,000	(Dr.) 4,500	(Cr.) 1,500	------

Adjustment Entry

	Particulars	Dr. ₹	Cr. ₹
	B's Capital A/c Dr.	4,500	
	To A/s Capital A/c		3,000
	To C's Capital A/c		1,500
	(Adjustment for remuneration, interest on capital and wrong distribution of profit)		

Illustration 19

X, Y and Z have been sharing profits in the ratio of 2 : 2 : 1 respectively. Z wants that he should be given equal share in profits with X and Y and he further wants that the change in the profits sharing ratio should come into effect retrospectively for the last three years. X and Y have no objection to this. The profit for last three years were, ₹ 60,000; ₹ 40,000 and ₹ 50,000.

Notes

Show the adjustment of profit for the last three years by means of a Journal entry.

Solution :

Table Showing Adjustments

		X ₹	Y ₹	Z ₹
Total Profits for the three years ₹60,000 + ₹40,000 + ₹50,000 = ₹1,50,000				
This Profit has already been divided in the ratio of 2 : 2 : 1	Dr.	60,000	60,000	30,000
If Profits are shared equally : $\frac{1,50,000}{3} = 50,000$	Cr.	50,000	50,000	50,000
Net Effect		Dr. 10,000	Dr. 10,000	Cr. 20,000

It is clear from the above table that X and Y, both have received ₹ 60,000 each, whereas each one of them should have received only ₹ 50,000 each. Therefore, X and Y will surrender ₹ 10,000 each in favour of Z.

Following adjustment entry will be passed for this purpose :

X's Capital A/c	Dr.	10,000	
Y's Capital A/c	Dr.	10,000	
To Z's Capital A/c			20,000
(Excess amount paid to X and Y now corrected)			

Illustration : 20

Ram, Mohan & Sohan are partners in a firm. They have omitted interest on capital @ 10% p.a. for three years ended 31st March 2014. Their fixed capitals on which interest was to be calculated throughout were :

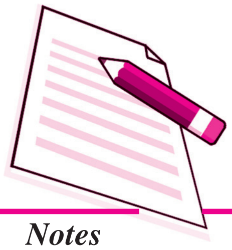
Ram : ₹ 10,00,000;   Mohan : ₹ 8,00,000;   Sohan : ₹ 7,00,000

Give the necessary adjusting journal entry with working.

Solution :

Calculation of Interest for 3 years :

		₹
A : 10% on ₹ 10,00,000 for 3 years	=	3,00,000



Notes

B : 10% on ₹. 8,00,000 for 3 years	=	2,40,000
C : 10% on ₹ 7,00,000 for 3 years	=	2,10,000
Total		7,50,000

Table Showing Adjustment

		Ram ₹	*Mohan* ₹	*Sohan* ₹	*Total* ₹
Interest on Capital	(Cr.)	3,00,000	2,40,000	2,10,000	7,50,000
Division of Rs. 7,50,000 in profit sharing ratio *i.e.* equally	(Dr.)	2,50,000	2,50,000	2,50,000	7,50,000
Difference		Cr. 50,000	Dr. 10,000	Dr. 40,000	------

Journal Entry

Date 2014	*Particulars*		*Dr.* ₹	*Cr.* ₹
Apr. 1	Mohan's Current A/c	Dr.	10,000	
	Sohan's Current A/c	Dr.	40,000	
	To Ram's Current A/c			50,000
	(Omission of interest on capital for three years rectified)			

Note : Since the capitals are fixed, Current Account will be debited or credited.

WHAT YOU HAVE LEARNT

- Characteristics of partnership are : (i) Agreement; (ii) Number of persons; (iii) Business; (iv) Sharing of Profits; (v) Unlimited liability; (vi) Management; (vii) Mutual Agency; (viii) Transferability of share
- **Partnership Deed :** The written form of the agreement. It is a document in which the terms and conditions regarding the conduct of the business and the relationship between the partners are laid down. If there is no partnership deed or it is silent on certain issues, the Partnership Act becomes applicable. These issues are : (i) Distribution of Profit; (ii) Interest on capital; (iii) Interest on drawings; (iv) Interest on partner's loan; (v) Salary and commission to partners
- **Capital Account :** The contribution made by the partner's in a business is called capital. This capital may be fixed or fluctuating.

(a) Fixed Capital Account- Two separate accounts are kept for each partner i.e. 'capital account' and 'current account'.

(b) Fluctuating Capital Account – Only one account for each partner is kept i.e. capital account,

- **Profit and Loss Appropriation Account :** All adjustments such as partner's salary, partner's commission, interest on capital, interest on drawings etc. are made through this account.

- **Guarantee of Porfit :** In this case a minimum amount of profit is guaranteed to a partner. This amount shall be given to him if his share of profit is lower than the guaranteed amount. The deficit shall be borne either by one of the old partners or by all the old partners in a particular agreed ratio. If nothing has been agreed, then in their old profit sharing ratio of the remaining partners. If his actual share of profit is more than the guaranteed amount, then, he will be given his actual share of profit.

- **Past Adjustments :** If after closing the accounts for the year it is discovered that some errors have been committed or some ommissions have been made then these errors have to be rectified. An adjustment entry has to be passed to rectify the error. The entries are made without disturbing the signed balance sheet only through the capital account. These entries are to rectify the errors committed in past, therefore they are known as 'Past Adjustments'.

TERMINAL EXERCISE

1. Explain the characteristics of a partnership.

2. In the absence of any partnership deed, what are the provisions that become applicable?

3. Distinguish between fixed and fluctuating capital accounts.

4. Why the Profit and Loss Appropriation Account is prepared?

5. A and B are partners in a firm. On January 1, 2013 their capital is ₹ 3,00,000 and ₹ 2,00,000 respectively. Their drawings during the year were ₹ 3,000 per month each. They allowed 6% interest on capital. The profit for the year ₹ 4,00,000. Calculate interest on capital for the year 2013 when capitals are fixed.

Notes

7. X and Y are equal partners. They withdrew ₹ 4,000 each per month. Calculate interest 4% p.a. on drawing in the following cases:

   (i) if they withdrew in the beginning of each month:

   (ii) if they withdrew at the end of each month:

   (iii) if they withdrew in the middle of each month:

8. Naman and Asmeta started business with capital of ₹ 1,00,000 each on January 1,2013. their drawings during the year were ₹ 1,000 and ₹ 500 per month respectively. The interest on drawing was ₹ 200 and ₹ 100 respectively. They are allowed interest on capital at 8% p.a. Naman is allowed a salary of ₹ 2,000 per month. They earned a profit of ₹ 94,000 before interest and salary. They share profit is the ratio of 2.1.

   Prepare Profit and Loss Appropriation Account for the year ended March 31, 2013 and Capital accounts of partners.

9. Rohan and Bhanu were partners in a firm and their balances on March 1, 2013 are as under:

	Rohan (₹)	Bhanu (₹)
Capital accounts	90,000	1,20,000
Current account	8,000 (Cr)	4,000 (Dr.)
Drawings	5,000	6,000

   Net profit for the year 2013 before charging interest on capital and partners salary was ₹ 25,600. They agree on the following:

   (i) Profit and losses to be shared equally.

   (ii) 6% interest is to be allowed on capital.

   (ii) Bhanu will be paid a monthly salary ₹ 9,000.

   Prepare Profit and Loss Appropriation Account for the year ended on March 31, 2013 and partners capital accounts.

10. The partnership agreement of M and R provides that:

   (i) Profit will be shared in the ratio of 3 : 2.

(ii) M will be allowed a salary of ₹ 500 p.m.

(iii) 8% interest will be allowed on partner's fixed capital accounts.

(iv) 6 % interest to be charged on partners drawings.

(v) The fixed capital of M and R is ₹ 2,00,000 and ₹ 1,50,000 respectively. Their drawings were ₹ 10,000 and ₹ 12,000 respectively. The net profit for the year ending December 2013 amounted to ₹ 62,000.

Prepare Profit and Loss Appropriation Account.

11. What do you mean by guarantee of profits? Explain in brief.

12. Explain Past Adjustments.

ANSWERS TO INTEXT QUESTIONS

22.1 I. (i) Two (ii) agreement (iii) written, oral (iv) partnership deed (v) unlimited

II. (i) No (ii) Yes (iii) No (iv) No (v) No

22.2 (i) Credit (ii) Fluctuating (iii) fixed (iv) Credit (v) Debit

22.3 I. (i) credited (ii) Debited (iii) Opening balance (iv)6½ months

II. Interest on capital Reema ₹ 6250 and Anish ₹ 8,000

III. Interest on Drawings ₹ 1100

22.4 (i) Partner's salary, partner's commission, interest on capital, interest on partner's loan.

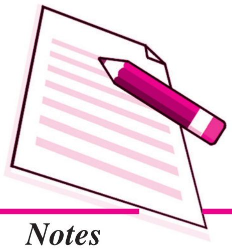
(ii) Profit and Loss Appropriation A/c Dr.
To Profit and Loss A/c

(iii) Interest on Drawings A/c Dr.
To Profit and Loss Appropriation A/c

ANSWERS TO TERMINAL EXERCISE

5. Interest on Capital to 'A' ₹ 18,000 and 'B' ₹ 12,000.

6. (i) ₹ 1,040, (ii) ₹ 880, (iii) ₹ .960.

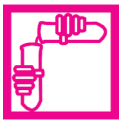


Notes

7. Profit distributed to Naman ₹ 36,200 and Asmeta ₹ 18,100
Balance in Capital A/c Naman ₹ 1,56,00 and Asmeta ₹ 1,20,000.

8. Profit distributed to Rohan ₹ 1,100 and Bhanu ₹ 1,100
Balance in current A/c Rohan ₹ 9,500 and Asmeta ₹ 9,100.

9. Profit distributed to M ₹ 17,592 and R ₹ 11,728



ACTIVITY

Make use of your communication skills to obtain Partnership Deed of five firms. Go through partnership deed of such firms. Identify the provisions which are not common. Also find out the important items that you would like to include in one of the partnership deeds.

	Name of the firm	*Items that are exclusive to the firm*	*Items to be included*
1.			
2.			
3.			
4.			
5.			

List of the items you suggest to be included in the partnership deeds

1. ....
2. ....
3. ....
4. ....
5. ....

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23

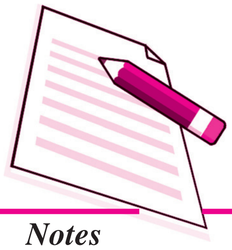
ADMISSION OF A PARTNER

Kapil and Krish are running a partnership firm dealing in toys. They are one of the most successful businessmen in the locality. They now decide to start manufacturing toys that are electronically operated to diversify their business. For this they need more capital and also technical expertise. Mohit; their friend is an electronic engineer and has capital also. They have persuaded him to join their firm. In case, he joins the partnership firm, this will be a case of admission of a partner. As a result, he may need to bring in capital and share of goodwill. In this lesson, you will learn about goodwill and other ajustments at the time of admission of a partner. Mohit will bring in capital and share of goodwill. Some changes in the value of some assets and liabilities of the existing firm are needed to bring them at their realistic value, on his admission. There may be other issues involing finance on his admission. All this need accounting treatment. In this lesson you will learn accounting treatment and adjustments to be made on the admission of a partner.

OBJECTIVES

After studying this lesson, you will be able to :

- state the meaning of admission of a partner;
- calculate new profit sharing ratio and sacrificing ratio;
- state the meaning and factors affecting goodwill;
- explain the methods of valuation of goodwill;
- describe accounting treatment of goodwill;



Notes

- explain the need for revaluation of assets and reassessment of liabilities;
- illustrate the accounting treatment of changes arising from revaluation of assets and reassessment of liabilities;
- describe accounting treatment of undistributed profits and reserves;
- explain the treatment of various adjustments in partners' capitals; and
- prepare Revaluation Account, Partners' Capital Accounts and balance sheet of the reconstituted firm.

23.1 ADMISSION OF A PARTNER

Meaning, New Profit Sharing Ratio and Sacrificing Ratio

Meaning

An existing partnership firm may take up expansion/diversification of the business. In that case it may need managerial help or additional capital. An option before the partnership firm is to admit partner/partners. When a partner is admitted to the existing partnership firm, it is called admission of a partner.

> *According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon.*

On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, Rekha and Nitesh are partners sharing profit in the ratio of 5:3. On April 1, 2014 they admitted Nitu as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Nitu as partner, the firm stands reconstituted.

On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio;

(ii) Adjustment of Goodwill;

(iii) Adjustment for revaluation of assets and reassessment of liabilities;

(iv) Distribution of accumulated profits and reserves; and

(v) Adjustment of partners' capitals.

Adjustment in Profit sharing Ratio

When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The incoming partner acquires his/her share of future profits either from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner, hence the calculation of new profit sharing ratio becomes necessary.

Sacrificing Ratio

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partners for acquiring the share of profit which they have surrendered in favour of the new partner.

Sacrificing Ratio is calculated as follows:

Sacrificing Ratio = Existing Ratio – New Ratio

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

(i) Only the new partner's share is given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

Illustration 1

Deepak and Vivek are partners sharing profit in the ratio of 3 : 2. They admit Ashu as a new partner for 1/5 share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

Solution:

Calculation of new profit sharing ratio:

Let total Profit = 1

Notes

New partner's share = 1/5

Remaining share = 1 – 1/5 = 4/5

Deepak's new share = 3/5 of 4/5 i.e. 12/25

Vivek's new share = 2/5 of 4/5 i.e. 8/25

Ashu's Share = 1/5

The new profit sharing ratio of Deepak, Vivek and Ashu is :

= 12/25 : 8/25 : 1/5 = 12 : 8 : 5/25 = 12 : 8 : 5

So Deepak Sacrificed = 3/5 – 12/25 = 15 – 12/25 = 3/25

Vivek Sacrificed = 2/5 – 8/25 = 10 – 8/25 = 2/25

Sacrificing Ratio = 3 : 2

Sacrificing ratio of the existing partners is same as their existing ratio.

(ii) The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.

In this case : the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice of share agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Illustration 2

Neha and Parteek are partners, sharing profit in the ratio of 5 : 3. They admit Nisha as a new partner for 1/6 share in profit. She acquires this share as 1/8 from Neha and 1/24 share from Parteek. Calculate the new profit sharing ratio and sacrificing ratio.

Solution :

Neha's and Parteek's existing ratio is 5 : 3

Neha's new share = 5/8-1/8 = 4/8 or 12/24

Parteek's new share = 3/8-1/24 = 8/24

Nisha's share = 1/8+1/24 =4/24

The new profit sharing ratio of Neha, Parteek and Nisha is

12/24 : 8/24 : 4/24

= 12 : 8 : 4 = 3 : 2 : 1

(ii) Sacrificing ratio = 1/8 : 1/24 or 3 : 1

(iii) Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificied share of the each partner is to be ascertained. This is ascertained by multiplying the existing partner's share in the ratio of their sacrifice. The share sacrificed by the existing partners should be deducted from his existing share. Therefore, the new share of the existing partners is determined. The share of the incoming partner is the sum of sacrifice by the existing partners.

Illustration 3

Him and Raj shared profits in the ratio of 5:3. Jolly was admitted as a partner. Him surrendered 1/5 of his share and Raj 1/3 of his share in favour of Jolly. Calculate the new profit sharing ratio.

Solution :

Him surrenders 1/5 of his share, i.e., = 1/5 of 5/8 = 1/8
Raj surrenders 1/3 of his share, i.e., = 1/3 of 3/8 = 1/8
So, sacrificing ratio of Him and Raj is 1/8 : 1/8 or equal.

Him's new share	=	5/8 – 1/8 = 4/8
and Raj's new share	=	3/8 – 1/8 = 2/8
Jolly's share	=	1/8 + 1/8 = 2/8

New profit sharing ratio of Him, Raj and Jolly is
= 4/8 : 2/8 : 2/8 or 4 : 2 : 2 or 2 : 1 : 1.

INTEXT QUESTIONS 23.1

I. Fill in the blanks with appropriate word/words :

(i) Sacrificing ratio is calculated by deducting .... share of profit from .... share of profit of the existing partners.

(ii) On admission of a new partner, the partnership firm is ....

(iii) The ratio in which partners surrender their profits is known as ....

(iv) The new ratio of existing partners is calculated by dividing remaining share of the profit in their ....

II. If Tarun and Nisha are partners sharing profits in the ratio of 5:3. What will be their sacrificing ratio if Rahul is admitted for 1/8 share of profit in the firm?

Notes

23.2 GOODWILL : MEANING, FACTORS AFFECTING GOODWILL AND VALUATION

Meaning of Goodwill

Over a period of time, a business firm develops a good name and reputation among the customers. This help the business earn some extra profits as compared to a newly set up business. In accounting, capitalised value of this extra profit is known as goodwill. For example, your firm earns say ₹1200 and the normal rate of profit expected to be earned by other similar firms in this industry is 10% say at this rate normal profit of your firm is ₹ 700 goodwill is ascertained as under :

Step 1 : Excess profit = Actual profit – Desired normal profit

$1200 - 700 = 500$

Step 2 : Goodwill $= 500 \times \dfrac{100}{10} =$ ₹ 5000

In other words, goodwill is the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit. It may also be defined as the present value of the capacity to earn future profits. This means that a firm can be said to have goodwill only if it has capacity to earn profit in future. A firm earning only normal profits like similar firms cannot claim to have any goodwill.

Factors affecting the Goodwill

The factors affecting goodwill are as follows:

1. **Location :** If the firm is located at a central place, resulting in good sale, the goodwill tends to be high.
2. **Nature of Business :** A firm that produces high value products or having a stable demand is able to earn more profits and therefore has more goodwill.
3. **Efficient management :** A well managed firm earns higher profit and so the value of goodwill will also be high.
4. **Quality :** If a firm is known for the quality of its products the value of goodwill will be high.
5. **Market Situation :** The monopoly condition leads to earn high profits which leads to higher value of goodwill.
6. **Special Advantages :** The firms which have special advantages like importing licenses, long term contracts for supply of material, patents, trademarks, etc. enjoy higher value of goodwill.

Methods of Valuation of Goodwill

The methods of valuation of goodwill are generally decided by the partners among themselves while preparing partnership deed. The following are the important methods of valuing the goodwill of a firm :

(i) Average Profit Method

(ii) Super Profit Method

(iii) Capitalisation Method

Let us learn about these methods.

1. **Simple Average Profit Method :** Under this method, average of the profits of certain given years is calculated. The value of the goodwill is calculated at an agreed number of years purchase of the average profit. Thus the goodwill is calculated as follows :

   Value of goodwill = Average Profit × Number of year of purchase

   For example, the average profits of a firm of say 3 years is ₹ 25,000 and the goodwill is to be calculated at 2 years purchase of the average profit. The value of the goodwill will be ₹ 50,000[₹ 25,000 × 2]. Thus goodwill = average profits × Number of years purchase.

Illustration : 4

The profit for the last five years of a firm were as follows Year 2001 ₹ 1,20,000: Year 2002 ₹ 1,50,000: Year 2003 ₹ 1,70,000: Year 2004 ₹ 1,90,000: Year 2005 ₹ 2,00,000. Calculate goodwill of the firm on the basis of 3 years purchases of 5 years average profits.

Solution :

Year	*Profit (₹)*
2001	1,20,000
2002	1,50,000
2003	1,70,000
2004	1,90,000
2005	2,00,000
Total	**8,30,000**

Average Profit = Total Profit/No. of Years

= ₹ 8,30,000/5 = ₹ 1,66,000

Goodwill = Average Profits × No. of years purchased

= ₹ 1,66,000 × 3 = ₹ 4,98,000

2. Super Profit Method : Super profit is the excess of actual profit over the normal profit. If a new business earns certain percentage of the capital employed, it is called 'normal profit'. The value of the goodwill is calculated at an agreed number of years purchase of super profit by multiplying the Super Profit by the certain number of years. Normal profit is that profit which is, earned by other business unit of the same business. Normal profit will be calculated as follows:

Normal profit = Capital employed × normal rate of return/100

Actual Profit : These are the profit earned during the year or it is also taken as the average of the last few years profit.

Super Profit = Actual Profit – Normal Profit

For example, A firm earns profit of ₹ 65,000 on a capital of ₹ 4,80,000 and the normal rate of return in similar business is 10%. Then the normal profit is ₹ 48,000[10% of the ₹ 4,80,000]. The actual profit is ₹ 65,000. Thus,

Super profit = Actual profit – Normal profit

= ₹ 65,000 – ₹ 48,000

= ₹ 17,000

If value of Goodwill is calculated by 3 years' purchase of super profit then goodwill is equal to ₹ 51,000[₹ 17,000 × 3].

Weighted average method : This method is a modified version of average profit method. In this method each year profit is assigned a weight i.e. 1, 2, 3, 4 etc. Thereafter each year profit is multiplied by the weight and find product. The total of products is divided by the total of weight. As a result we find the weighted average profit. After this the value of goodwill is calculated multiplying the weighted average profit by the agreed number of year's purchase. Thus the goodwill is calculated as follows :

$$\text{Weighted average profit} = \frac{\text{Total product of profit}}{\text{Total of weights}}$$

Value of goodwill = Weighted average profit × number of year of purchase

(Note : This method is used when we observe that there is a tendency to increase the annual profits. Latest year profit is assigned the highest weight.

Illustration : 5

The profit of firm for past years were as follow :

	Profit ₹
2002	80,000
2003	85,000
2004	90,000
2005	1,00,000
2006	1,10,000

The weight to be used are 1, 2, 3, 4, and 5 for the years from 2002 - 2006.

Calculate the value of goodwill on the basis of two year's purchase of weighted average profit.

Solution :

Year	*Profit*	*Weight*	*Products*
2002	80,000	1	80,000
2003	85,000	2	1,70,000
2004	90,000	3	2,70,000
2005	1,00,000	4	4,00,000
2006	1,10,000	5	5,50,000
		15	14,70,000

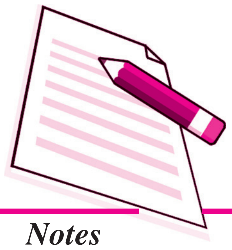
$$\text{Weighted Average Profit} = \frac{14,70,000}{15} = ₹\ 98,000$$

Goodwill = ₹ 98000 × 2 = ₹ 1,96,000

Illustration : 6

A firm earned the following net profits during the last 4 years

	₹
2003	90,000



Notes

2004	1,20,000
2005	1,60,000
2006	1,80,000

Capital employed in the firm is ₹10,00,000. The normal rate of profit is 10%. Calculate the value of the goodwill on the basis of 4 year purchase of super profit.

Solution :

Total profit of 4 years = ₹ 90,000 + ₹ 1,20,000 + ₹ 1,60,000 + ₹ 1,80,000
= ₹ 5,50,000

Average annual profit = ₹ 5,50,000/4
= ₹ 1,37,500

Normal Profit = 10% of ₹ 10,00,000 = ₹ 10,00,000 × 10/ 100
= ₹ 1,00,000

Super profit = ₹ 1,37,500 – ₹ 1,00,000
= ₹ 37,500

Value of goodwill at 4 years' purchase = ₹ 37,500 × 4 = ₹ 1,50,000

3. Capitalisation Method : In this method, goodwill is the amount of capital saved. Normally businessmen invest capital to operate business activities, and earn profit with the efficient utilisation of capital. If the business earns more profit by investing lesser amount of capital as compared to other business, who earned same amount of profit with more amount of capital, the saved amount is assumed to be goodwill.

Under this method, the Goodwill is calculated in two ways:

i. Capitalisation of Average profit

ii. Capitalisation of Super profit

i. Capitalisation of Average Profit : In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed.

Following formula is applied for Calculation of capital employed:

Capital employed = Total Assets – Outsider Liabilities

Notes

Following formula is applied for calculation of capitalised value of profit :

Capitalised Value of Profit = Average Profit × 100/ Normal Rate of Profit

Goodwill = Capitalised Value of Profits – Capital Employed

Illustration : 7

A firm earned average profit during the last few years is ₹ 40,000 and the normal rate of return in similar business is 10%. The total assets is ₹ 3,60,000 and outside liabilities is ₹ 50,000. Calculate the value of goodwill with the help of Capitalisation of Average profit method.

Solution :

Capital employed = Total assets - Outside liabilities
= ₹ 3,60,000 - ₹ 50,000
= ₹ 3,10,000

Capitalised value of average profit = Average Profit × 100/ Normal rate of profit
= ₹ 40,000 × 100/10
= ₹ 4,00,000

Goodwill = Capitalised value – Capital employed
= ₹ 4,00,000 – ₹. 3,10,000
= ₹ 90,000

Illustration : 8

The capital invested in a firm is ₹ 4,60,000 and the rate of return in the similar business is 12%. The firm earns the following profit in the last 4 years:

2003	₹ 60,000	2005	₹ 80,000
2004	₹ 70,000	2006	₹ 90,000

Calculate the value of goodwill by Capitalisation method.

Solution :

Total Profit = ₹ 60,000 + ₹ 70,000 + ₹ 80,000 + ₹ 90,000/4

Average Profit = ₹ 3,00,000/4
= ₹ 75,000

Notes

Capitalised Value = Average profit × 100/12
= ₹ 75,000x100/12
= ₹ 6,25,000

Goodwill = Capitalised value – Capital employed
= ₹ 6,25,000 – ₹ 4,60,000
= ₹ 1,65,000

ii. ***Capitalisation of Super Profit :*** In this method, the value of goodwill is calculated on the basis of super profit method. Goodwil is the capitalised value of super profit. Following formula is applied for Calculation of capitalised value *i.e.,* goodwill.

Goodwill = Super Profit × 100/Normal Rate of Profit

Illustration : 9

A firm earns a profit of ₹ 26,000 and has invested capital amounting to ₹ 2,20,000. In the same business normal rate of earning profit is 10%. Calculate the value of goodwill with the help of Capitalisation of super profit method.

Solution :

Actual profit = ₹ 26,000

Normal profit = ₹ 2,20,000 x 10/ 100 = ₹ 22,000

Super Profit = Actual Profit – Normal Profit
= ₹ 26,000 – ₹ 22,000
= ₹ 4,000

Goodwill = Super profit × 100/normal rate of profit
= ₹ 4,000 × 100/10
= ₹ 40,000

INTEXT QUESTIONS 23.2

I. Fill in the blanks with appropriate word/words :

(i) Goodwill is an .... asset.

(ii) The amount of goodwill is generally brought in by .... Partner.

Notes

(iii) Super Profit = Actual Profit – ....

(iv) The methods of calculating goodwill are .... and ....

(v) Capital employed = Total assets minus ....

II. (a) From the following information, Calculate average profit :

Year	*Profit (₹)*	*Loss (₹)*
2001	80,000	
2002	90,000	
2003	—	30,000
2004	1,10,000	

Average Profit = ₹

(b) Calculate value of goodwill at two year's purchase of average profit, ascertained in II(a) above.

23.3 TREATMENT OF GOODWILL

The new partner acquires his/her share of profit from the existing partners. This will result in the reduction of the share of existing partners. Therefore, he/she compensates the existing partners for the sacrifices. He/she compensates them by making payment in cash or in kind. The payment is equal to his/her share in the goodwill.

As per Accounting Standard 10(AS-10) that goodwill should be recorded in the books only when some consideration in money has been paid for it. Thus, if a new partner does not bring necessary cash for goodwill, no goodwill account can be raised in the books. He/she should pay for goodwill in addition to his/her contribution for capital.

If, he/she does not pay for goodwill, then amount equal to his/her share of goodwill will be deducted from the capital. The amount brought in by him/her as goodwill or amount of goodwill deducted from his/her capital is divided between the existing partners in their sacrificing ratio. At the time of admission of a new partner any goodwill appearing in the books, will be written off in existing ratio among the existing partners.

There are different situations relating to treatment of goodwill at the time of admission of a new partner. These are discussed as under:

1. When the amount of goodwill is paid privately by the new partner.
2. When the new partner brings his/her share of goodwill in cash.
3. When the new partner does not bring his/her share of goodwill in cash.

1. The amount of goodwill is paid privately by the new partner : If the amount of goodwill is paid by the new partner to the existing partner privately, no journal entries are made in the books of the firm.

2. The new partner brings his/her share of goodwill in cash and the amount of goodwill is retained in the Business : When, the new partner brings his/her share of goodwill in cash. The amount brought in by the new partner is transferred to the existing partners in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partners, it will be written off immediately in existing ratio among the partners. The journal entries are as follows:

(i) The existing goodwill in the books of the firm will be written off in existing profit ratio as;

Existing Partners Capital A/c Dr. [individually]
    To Goodwill A/c
(Existing goodwill written off)

(ii) For bringing cash for Capital and goodwill

Cash/Bank A/c Dr.
    To Goodwill Premium A/c
    To New partner's Capital A/c
(Cash brought in for capital and goodwill)

(iii) For amount of goodwill transferred to existing partner capital account:

Goodwill A/c Dr.
    To Existing Partner's Capital/current A/c [individually]
(The amount of goodwill credited to existing partner's capitals in sacrificing ratio)

Illustration : 10

Tanaya and Sumit are partners in a firm sharing profit in the ratio 5 : 3. They admitted Gauri as a new partner for 1/4th share in the profit. Gauri brings ₹ 30,000 for her share of goodwill and ₹ 1,20,000 for capital. Make journal entries in the books of the firm after the admission of Gauri. The new profit sharing ratio will be 2 : 1 : 1.

Notes

Solution :

Books of Tanaya, Sumit and Gauri

Date	*Particulars*		*LF*	*Debit Amount (₹)*	*Credit Amount (₹)*
1.	Bank A/c	Dr.		1,50,000	
	To Goodwill Premium A/c				30,000
	To Gauri's Capital A/c				1,20,000
	(cash brought by Gauri for her share of goodwill and capital)				
	Goodwill Premium A/c	Dr.		30,000	
	To Tanaya's Capital A/c				15,000
	To Sumit's Capital A/c				15,000
	(Goodwill transferred to existing partners capital account in their sacrificing ratio)				

Working Note:

Calculation of sacrificing ratio [existing ratio – new ratio]

Partners	*Existing Ratio*	*New Ratio*	*Sacrifice*	*Sacrificing Ratio*
Tanaya	5/8	2/4	5/8 – 2/4 = 1/8	Tanaya : Sumit
Sumit	3/8	1/4	3/8 – 1/4 = 1/8	1 : 1

The amount of goodwill is withdrawn by the existing partners:

(iv) Existing Partners Capital/current A/c Dr. [individually]
To Cash/Bank A/c
(The amount of goodwill withdrawn by the existing partners)

It is to be noted that sometimes partner's withdraw only 50% or 25% amount of goodwill. In such a case, entry will be made for the withdrawn amount only.

Illustration : 11

In previous illustration, it is assumed that the full amount of goodwill is withdrawn by Tanaya and Sumit . Make journal entry in the books of the firm.

Notes

Solution :

Books of Tanaya, Sumit and Gauri

Date	*Particulars*	*LF*	*Debit amount* ₹	*Credit amount* ₹
	Tanaya's Capital A/c Dr.		15,000	
	Sumit's Capital A/c Dr.		15,000	
	To Bank A/c			30,000
	(Amount of Goodwill is withdrawn by them)			

3. **New partner does not bring his/her share of goodwill in cash :** When the goodwill of the firm is calculated and the new partner is not able to bring his/her share of goodwill in cash, goodwill will be adjusted through new partner's capital accounts. In this case new partner's capital account is debited for his/her share of goodwill and the existing partner's capital accounts are credited in their sacrificing ratio. The journal entry is as under:

   New Partner's Capital A/c Dr.

   To Existing Partner's Capital A/c [individually in sacrificing ratio]

   (New partner's share in goodwill credited to exisitng partner's in sacrificing ratio)

Goodwill appears in the books of the firm and new partner does not bring his/her share of goodwill in cash

If the goodwill account appears in the books of the firm, and the new partner is not able to bring goodwill in cash. In this case, the amount of goodwill existing in the books is written off by debiting the capital account of existing partners in their existing profit sharing ratio.

Illustration 12

Ashmita and Sahil are partners sharing profit in the ratio of 3 : 2. They agree to admit Charu for 1/5 share in future profit. Charu brings ₹ 2,50,000 as capital and unable to bring her share of goodwill in cash, the goodwill of the firm to be valued at ₹ 1,80,000. At the time of admission goodwill existed in the books of the firm at ₹ 80,000. Make necessary journal entries in the books of the firm.

Solution :

Books of Ashmita, Sahil and Charu

Date	*Particulars*	*LF*	*Debit amount* ₹	*Credit amount* ₹
	Bank A/c Dr.		2,50,000	
	To Charu's Capital A/c			2,50,000
	[Cash brought by Charu for her capital]			
	Ashmita's Capital A/c Dr.		48,000	
	Sahil's Capital A/c Dr.		32,000	
	To Goodwill A/c			80,000
	[Goodwill written off before Charu's admission]			
	Charu's Capital A/c Dr.		36,000	
	To Ashmita's Capital A/c			21,600
	To Sahil's Capital A/c			14,400
	[Existing partners capital a/c credited for goodwill on Charu's admission in sacrificing ratio]			

Working Note :

Ashmita and Sahil sacrifice their profit in favour of Charu in their existing profit sharing ratio i.e. 3 : 2. Therefore, the sacrificing ratio is 3 : 2.

Value of Goodwill = ₹ 1,80,000

Charu's share in Profit = 1/5

Charu's share of Goodwill = ₹ 1,80,000 × 1/5 = ₹ 36,000

New partner brings in only a part of his share of goodwill

When new partner is not able to bring the full amount of his/her share of goodwill in cash and brings only a part of cash. In this case, the amount of goodwill brought by him is credited to goodwill account. At the time of goodwill transferred to capital account of existing partner's, new partner's capital account is debited with his unpaid share of goodwill besides debiting goodwill account with the amount of goodwill is paid by him. The journal entries is as

Notes

Bank A/c Dr.
To Goodwill Premium A/c
[Part Amount of goodwill brought by new partnerI

Goodwill Premium A/c Dr.
New Partner's Capital A/c Dr.
To Existing Partner's Capital A/c [individually in sacrificing ratio]
[Credit given to sacrificing partner by new partner's in full share of goodwill]

Illustration 13

Tanu and Puneet are partners sharing profit in the ratio of 5 : 3. They admit Tarun into the firm for 1/6 share in profit which he takes 1/ 18 from Tanu and 2/ 18 from Puneet. Traun brings ₹ 9,000 as goodwill out of his share of ₹ 12,000. No goodwill account appears in the books of the firm. Make necessary journal entries in the books of the firm.

Solution :

Journal

Date	*Particulars*	*LF*	*Debit Amount ₹*	*Credit Amount ₹*
	Bank A/c Dr		9,000	
	To Goodwill Premium A/c			9,000
	[A part of his share of goodwill brought in by Tarun]			
	Goodwill Premium A/c Dr.		9,000	
	Tarun Capital A/c Dr.		3,000	
	To Tanu's Capital A/c			4,000
	To Puneet's Capital A/c			8,000
	[Goodwill credited to Tanu and Puneet in their sacrificing ratio i.e 1 : 2]			

INTEXT QUESTIONS 23.3

I. Fill in the blanks with appropriate word/words

(a) When Goodwill is paid privately, ... will be made.

(b) If the new partner brings amount of goodwill, the amount of goodwill brought by him is .... to goodwill account.

(c) The amount brought in by the new partner is transferred to the existing partner in the .... ratio

(d) Goodwill appearing in the books of the firm is at the time of admission of a new partner ....

(e) If the new partner is not able to bring his share of goodwill, The new partner's capital account is .... for his share of goodwill

II. Match the appropriate entry of Column B with that of Column A. by writing the correct numbers of the column B in the space provided.

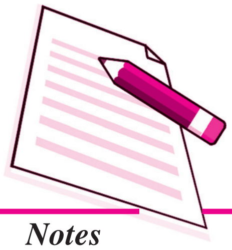
Column A	*Column B*
1. Goodwill is paid privately	i. Existing Partners Capital A/c To Goodwill A/c
2. New partner is not able to bring cash for Goodwill.	ii. Goodwill Premium A/c Dr. To Existing partner's Capital A/c
3. At the time of admission the goodwill appearing in the books is written off.	iii. New Partner's Capital A/c Dr. To Existing Partner's Capital A/c To Existing Partner's Capital A/c
4. At the time of admission the amount of goodwill brought by the new partner is transferred to sacrificing partners' capital A/c.	iv. No Entry

ACCOUNTING TREATMENT OF RESERVES AND ACCUMULATED PROFITS/LOSSES

When There is Change in Profit Sharing Ratio of Existing Partner's

Case (i) When Reserves and Accumulated Profits/Losses are to be transferred to Capital Accounts :

If, at the time of change in the profit sharing ratio, there are Reserves or Accumulated profits/losses existing in the books of the firm, these should be transferred to the Partner's Capital Accounts (if capitals are fluctuating) or to partners Current Account



Notes

(if capitals are fixed) in their old profit sharing ratio. The reason for such transfer is that these reserves and accumulated profits/losses have come into existence before the change in profit sharing ratio and hence belong to the partners in their old profit sharing ratio. Following entries are passed for this purpose :

i. For Transfer of Reserves and Accumulated Profits :

Reserve A/c	Dr.	
Profit & Loss A/c	Dr.	
Workmen's Compensation Reserve A/c	Dr.	(Excess of Reserve over Actual Liability)
Investment Fluctuation Reserve A/c	Dr.	(Excess of Reserve Over difference between Book value and Market value)
To Old Partner's Capital or Current A/cs	Dr.	(in Old Profit Sharing Ratio)

(Being the undivided Profit/Reserves transferred to Partners Capital Current A/c)

ii. For Transfer of Accumulated Losses :

Old Partner's Capital or Current A/cs.	Dr.	(in Old Profit Sharing Ratio)
To Profit & Loss A/c		
To Deferred Revenue Expenditure A/c	(for example Advertisement Suspense A/c)	

(Being the Losses/................ on assets transferred to partner capitals/................)

Illustration 14

Sita and Geeta are partners sharing profits and losses in the ratio of 2 : 1. From April 1, 2013, they decided to share the profits in the ratio of 3 : 2. On that date, profit and loss account showed a debit balance of ₹ 6,00,000. Record the necessary journal entry for the distribution of the balance in the Profit and Loss Account.

Solution :

Journal

Date	*Particulars*		*L.F.*	*Dr. (₹)*	*Cr. (₹)*
2013					
Apr. 1	Sita's Capital A/c (2/3)	Dr.		4,00,000	
	Geeta's Capital A/c (1/3)	Dr.		2,00,000	
	To Profit and Loss A/c				6,00,000
	(Transfer of undistributed loss on change in profit sharing ratio)				

Illustration 15

A, B and C are partners sharing profits in the ratio of 4 : 3 : 2. From April 1, 2014 they decided to share the profits equally. On that date their books showed a credit balance of ₹ 36,00,000 in the Profit and Loss Account and a balance of ₹ 9,00,000 in the General Reserve. Record the necessary journal entry for the distribution of profits and the general reserve.

Solution :

Journal

Date	*Particulars*		*L.F.*	*Dr. (₹)*	*Cr. (₹)*
2014					
April 1	Profit & Loss A/c	Dr.		36,00,000	
	General Reserve A/c	Dr.		9,00,000	
	To A's Capital A/c (4/9)				20,00,000
	To B's Capital A/c (3/9)				15,00,000
	To C's Capital A/c (2/9)				10,00,000
	(Transfer of undistributed profit and general reserve on change in profit sharing ratio)				

Illustration 16

X, Y and Z sharing profits and losses in the ratio of 3 : 2 : 1, decide to share future profits and losses in the ratio of 4 : 3 : 2 with effect from 1st April, 2014. Following an extract of their Balance Sheet as at 31st March, 2014 :

Notes

Liabilities	₹	Assets	₹
Workmen Compensation Reserve	3,00,000		

Show the accounting treatment under the following alternative case :

Case (i) If there is no other information.

Case (ii) If a claim on account of workmen's compensation is estimated at ₹ 1,20,000

Solution :

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
2014				
April 1	*Case (i)*			
	Workmen Compensation Reserve A/c Dr.		3,00,000	
	To X's Capital A/c			1,50,000
	To Y's Capital A/c			1,00,000
	To Z's Capital A/c			50,000
	(Transfer of Workmen Compensation Reserve to partner's capital accounts in their old profit sharing ratio)			
	Case (ii)			
	Workmen Compensation Reserve A/c Dr.		3,00,000	
	To Provision for Workmen Compensation Claim A/c			1,20,000
	To X's Capital A/c			90,000
	To Y's Capital A/c			60,000
	To Z's Capital A/c			30,000
	(Transfer of excess Compensation Reserve to partner's capital accounts in their old profit sharing ratio)			

Case (ii) When Reserves and Accumulated Profit/Loss are not to be transferred to Capital Accounts or to be continued in future Balance Sheet :

If, in case of change in profit sharing ratio, there are reserves and accumulated profits appearing in the old Balance Sheet and the partners decide to leave the reserves and accumulated profits undistributed, it will be necessary to pass an adjusting entry for the same. This is, because, at present the partners are entitled to share such reserves and profits in the old profit sharing ratio whereas in future they will be entitled to share such reserves and profits in the new profit sharing ratio. Hence, the gaining partner must compensate the sacrificing partner that share of reserves and profits which is proportionate to the share gained by him/her. For example, suppose P and Q sharing profits in the ratio of 2 : 1 decide to share future profits in equal proportion. Reserves appearing in the Balance Sheet amount to ₹ 6,00,000 and the partners do not want to distribute them. In such a case a present P is entitled to ₹ 4,00,000 and Q ₹ 2,00,000 of such reserves but in future, after the change in the profit sharing ratio, each would be entitled to ₹ 3,00,000. Hence, Q must compensate P to the extent of ₹ 1,00,000. This amount is proportionate to the $\frac{1}{6}$ th share $(i.e. \frac{1}{2} - \frac{1}{3})$ gained by him.

The adjustment for this amount is usually made by passing the following adjustment entry :

	Particulars	*L.F.*	*Dr. (₹)*	*Cr. (₹)*
	Q's Capital A/c Dr.		1,00,000	
	To P's Capital A/c			1,00,00
	(Being adjustment made in the capital A/cs of the partner for Reserves)			

Illustration 17

M and N are partners in a firm sharing profits in the ratio of 4 : 3. On March 31, 2014 their Balance Sheet showed a General Reserve of ₹ 7,00,000. On that date they decided to change their profit sharing ratio which will be 5 : 3. Record necessary journal entries in the books of the firm under the following circumstances :

i. When they decided to transfer the general reserve to their capital accounts.

Notes

ii. When they don't want to transfer general reserve in their capital A/c but prefer to record an adjustment entry for the same.

Solution :

Alternative (i) When General Reserve in transferred to Capital Accounts:

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2014 Mar. 31	General Reserve A/c Dr. To M's Capital A/c To N's Capital A/c (General reserve transferred to the Capital A/c of partners on the reconstitution of the firm)	7,00,000	 4,00,000 3,00,000

Alternative (ii) When General Reserve is not transferred to Capital Accounts:

Old Profit Sharing Ratio of M and N = 4 : 3

New Profit Sharing Ratio of M and N = 5 : 3

Sacrifice or Gain :

$$M = \frac{4}{7} - \frac{5}{8} = \frac{32-35}{56} = \frac{3}{56} \text{ gain}$$

$$N = \frac{3}{7} - \frac{3}{8} = \frac{24-21}{56} = \frac{3}{56} \text{ sacrifice}$$

Therefore, M's Capital A/c will be debited & N's capital A/c will be credited with $\frac{3}{56}$th proportions.

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
	M's Capital A/c Dr. To N's Capital A/c (Adjustment to General Reserve A/c when it is not to be closed)	37,500	 37,500

Illustration 18

X and Y were partners in a firm sharing profits in the ratio of 3 : 1. With effect from 1st January 2014 they agreed to share profits in the ratio of 2 : 1. For this purpose the goodwill of the firm was valued at ₹ 5,00,000. General reserves appear in the books at ₹ 4,00,000. Partners neither want to show goodwill in the books nor want to distribute the reserves. You are required to record the change by passing a single journal entry.

Solution :

	₹
Value of goodwill	5,00,000
General Reserve	4,00,000
	9,00,000

Old Ratio of X and Y 3 : 1

New Ratio of X and Y 2 : 1

Sacrifice or Gain :

$$X = \frac{3}{4} - \frac{2}{3} = \frac{9-8}{12} = \frac{1}{12} \text{ (Sacrifice)}$$

$$Y = \frac{1}{4} - \frac{1}{3} = \frac{3-4}{12} = \frac{1}{12} \text{ (Gain)}$$

X will be compensated by Y to the extent of $\frac{1}{12}$ of ₹ 9,00,000 = ₹ 75,000

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2014 Jan. 1	Y's Capital A/c Dr.	75,000	
	To X's Capital A/c		75,000
	(Adjustment for goodwill and reserves on change in profit sharing ratio)		

Illustration 19

P, Q and R are partner sharing profits and losses in the ratio of 2 : 3 : 4. They decided to share future profits and losses in the ratio of 4 : 3 : 2. They alsio decided to record the effect of the following without affecting their book values:

	₹
General Reserve	4,00,000
Profit & Loss A/c	2,00,000
Advertisement Suspense A/c	1,50,000

You are required to give the necessary single adjustment entry for the same.

Notes

Solution :

Calculation of Net Effect of Accumulated Profit/Losses :

	₹
General Reserve	4,00,000
(+) Profit & Loss A/c	2,00,000
(-) Advertisement Suspense A/c	1,50,000
Net Amount	4,50,000

Calculation of Sacrifice or Gain :

Old Ratio of P, Q and R $\frac{2}{9} : \frac{3}{9} : \frac{4}{9}$

New Ratio of P, Q and R $\frac{4}{9} : \frac{3}{9} : \frac{2}{9}$

Sacrifice or Gain :

P $\frac{2}{9} - \frac{4}{9} = \frac{2}{9}$ (Gain)

Q $\frac{3}{9} - \frac{3}{9} = 0$ (No Profit no loss)

R $\frac{4}{9} - \frac{2}{9} = \frac{2}{9}$ (Sacrifice)

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	P's Capital A/c (2/9 of 4,50,000) Dr.		1,00,000	
	To R's Capital A/c (2/9 of 4,50,000)			1,00,000
	(Adjustment for general reserve, profit & loss account balance and advertisement suspense account on change in profit sharing ratio)			

Illustration 20

A, B and C sharing profits and losses in the ratio of 1 : 2 : 2, decided to share future profits equally with effect from 1st April, 2013. On that date, Profit & Loss Account showed a credit balance of ₹ 2,40,000. Partners do not want to distribute the profit but prefer to record the change in the profit sharing ratio by passing an adjustment entry. You are required to give the adjusting entry.

Solution :

Old Ratio of A, B and C $\frac{1}{5}:\frac{2}{5}:\frac{2}{5}$

New Ratio of A, B and C $\frac{1}{3}:\frac{1}{3}:\frac{1}{3}$

Sacrifice or Gain :

A = $\frac{1}{5}-\frac{1}{3}$ = $\frac{3-5}{15}$ = (Gain)

B = = $\frac{6-5}{15}$ = (Sacrifice)

$\frac{4}{15}$ $\frac{2}{5}$ $\frac{1}{3}$

C = $\frac{2}{5}-\frac{1}{3}$ = $\frac{6-5}{15}$ = (Sacrifice)

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2014				
Apr. 1	A's Capital A/c (2/15 of 2,40,000) Dr.		32,000	
	To B's Capital A/c (1/15 of 2,40,000)			16,000
	To C's Capital A/c (1/15 of 2,40,000)			16,000
	(Adjustment for Profit and Loss Account balance on change in profit sharing ratio)			

23.4 ACCOUNTING TREATMENT OF GOODWILL WHEN THERE IS CHANGE IN THE PROFIT SHARING RATIO OF EXISTING PARTNERS

A change in profit sharing ratio basically implies that one partner is purchasing from another partner, a share of profits previously belonging to the latter. The purchasing

Notes

or gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill. In other words, the gaining partner should pay the sacrificing partner that share of goodwill which is equal to the share gained by him. For example, suppose A and B are sharing profits in the proportion of $\frac{4}{5}:\frac{1}{5}$. If it is decided that in future they will share porfits in the proportion of $\frac{3}{5}:\frac{2}{5}$, it implies that A is selling $\frac{1}{5}$th $\left(\frac{4}{5}-\frac{3}{5}\right)$ of his share to B. If the profits of the firm are ₹ 1,00,000 p.a. A will lose ₹ 20,000 and B will gain ₹ 20,000 annually. This must be compensated by B by paying to A an amount equal to $\frac{1}{5}$th of total present value of goodwill of the firm. If the goodwill is valued at ₹ 5,00,000 B must pay to A $\frac{1}{5}$th of ₹ 5,00,000 *i.e.,* ₹ 1,00,000.

Such an adjustment is made by passing an adjustment entry wherein B's Capital Account will be debited and A's Capital Account will be Credited by ₹ 1,00,000.

Illustration 21

M and N were partners in a firm sharing profits in the ratio of 3 : 2. With effect from 31st March 2014 they agreed to share profits equally. For this purpose the goodwill of the firm was valued at ₹ 3,00,000. Pass the necessary adjustment entry :

Solution :

Old Ratio of M and N	=	3 : 2
New Ratio of M and N	=	1 : 1

Sacrifice or Gain :

$$M = \frac{3}{5}-\frac{1}{2}=\frac{6-5}{10}=\frac{1}{10} \text{ (Sacrifice)}$$

$$N = \frac{2}{5}-\frac{1}{2}=\frac{4-5}{10}=\frac{1}{10} \text{ (Gain)}$$

Since M has sacrificed, he will be credited by $\frac{1}{10}$ of ₹. 3,00,000 i.e. ₹ 30,000

Since N has gained, he will be debited by $\frac{1}{10}$ of ₹ 3,00,000 i.e. ₹ 30,000

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
2014				
Mar.31	N's Capital A/c	Dr.	30,000	
	To M's Capital A/c			30,000
	(Adjustment for goodwill due to change in profit sharing ratio)			

Illustration 22

A, B and C are partners sharing profits equally. They decided that in future C will get $\frac{1}{5}$th share in profits. On the day of change, firms's goodwill has been valued at ₹ 6,00,000. Make the necessary adjustment entry for the treatment of goodwill.

Solution :

Old Ratio of A, B and C $= \frac{1}{3}:\frac{1}{3}:\frac{1}{3}$

New Ratio of A, B and C $= \frac{2}{5}:\frac{2}{5}:\frac{1}{5}$

Sacrifice or Gain :

$$A = \frac{1}{3}-\frac{2}{5}=\frac{5-6}{15}=\frac{1}{15} \text{ (Gain)}$$

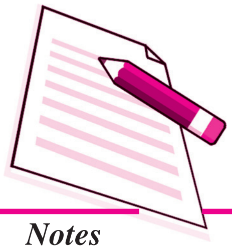
$$B = \frac{1}{3}-\frac{2}{5}=\frac{5-6}{15}=\frac{1}{15} \text{ (Gain)}$$

$$C = \frac{1}{3}-\frac{1}{5}=\frac{5-3}{15}=\frac{2}{15} \text{ (Sacrifice)}$$

Calculation of share of Loss or gain of Goodwill

Total Goodwill ₹ 6,00,000

A's Share of loss = $\frac{1}{15}$ of ₹ 6,00,000 = ₹ 40,000



Notes

B's Share of loss = $\frac{1}{15}$ of ₹ 6,00,000 = ₹ 40,000

C's Share of Gain = $\frac{2}{15}$ of ₹ 6,00,000 = ₹ 80,000

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	A's Capital A/c (1/15 of 6,00,000)	Dr.	40,000	
	B's Capital A/c (1/15 of 6,00,000)	Dr.	40,000	
	To C's Capital A/c (2/15 of 6,00,000)			80,000
	(C compensated by A and B for the sacrifice made by him)			

Illustration 23

P, Q and R are partners sharing profits and losses in the ratio of 5 : 4 : 1. It was decided that with effect from 1st January 2014 the profit sharing ratio will be 9 : 6 : 5. Goodwill is to be valued at 2 year's purchase of average of 3 year's profits. The profits for 2011, 2012 and 2013 were ₹ 96,000; ₹ 84,000 and ₹ 1,20,000 respectively.

Pass the necessary journal entry for the treatment of goodwill without opening Goodwill Account.

Solution :

Average Profit = ₹ $\frac{96,000+84,000+1,20,000}{3}$ = ₹ 1,00,000

Value of Goodwill at 2 year's purchase = ₹ 1,00,000 x 2 = ₹ 2,00,000

Old Ratio of P, Q and R = 5 : 4 : 1

New Ratio of P, Q and R = 9 : 6 : 5

Sacrifice or Gain :

P = (Sacrifice)

Q = $\frac{4}{10}-\frac{6}{20}=\frac{8-6}{20}=\frac{2}{20}$ (Sacrifice)

Notes

$$R = \frac{1}{10} - \frac{5}{20} = \frac{2-5}{20} = \frac{3}{20} \text{ (Gain)}$$

Since P has sacrificed, he will be credited by $\frac{1}{20}$ of ₹ 2,00,000 = ₹ 10,000

Since Q has sacrificed, he will be credited by $\frac{2}{20}$ of ₹ 2,00,000 = ₹ 20,000

Since R has gained, he will be debited by $\frac{3}{20}$ of ₹ 2,00,000 = ₹ 30,000

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
2014				
Jan. 1	R's Capital A/c	Dr.	30,000	
	To P's Capital A/c			10,000
	To Q's Capital A/c			20,000
	(Treatment for goodwill due to change in profit sharing ratio)			

Illustration 24

A, B and C are partners sharing profits in the ratio of 3 : 2 : 1. It is now agreed that they will share the future profits equally. Goodwill of the firm is valued at ₹ 3,00,000. The goodwill of the firm does not appear in the books. Pass necessary adjustment entry for the treatment goodwill.

Solution :

Old Ratio of A, B and C = 3 : 2 : 1

New Ratio of A, B and C = 1 : 1 : 1

Sacrifice or Gain :

$$A = \frac{3}{6} - \frac{1}{3} = \frac{3-2}{6} = \frac{1}{6} \text{ (Sacrifice)}$$

$$B = \frac{2}{6} - \frac{1}{3} = \frac{2-2}{6} = 0$$

$$C = \frac{1}{6} - \frac{1}{3} = \frac{1-2}{6} = \frac{1}{6} \text{ (Gain)}$$

Notes

Since A has sacrificed, he will be credited for $\frac{1}{6}$ of ₹ 3,00,000 = ₹ 50,000

Since C has gained, he will be debited for $\frac{1}{6}$ of ₹ 3,00,000 = ₹ 50,000

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
2014				
Jan. 1	C's Capital A/c	Dr.	50,000	
	To A's Capital A/c			50,000
	(Adjustment for goodwill due to change in profit sharing ratio)			

Illustration 25

Ram and Ramesh were partners sharing profits and losses in the ratio of 3 : 1. They decided that with effect from 1st January 2013, they would share profits and losses in the ratio of 5 : 3. The partnership deed provides that in the event of any change in profit sharing ratio, the goodwill should be valued at the total of two year's profits preceding the date the decision became effective. The profits for 2010, 2011 and 2012 were ₹ 6,00,000; ₹ 7,00,000 and ₹ 9,00,000 respectively. Pass the necessary Journal entry to give effect to the above arrangement.

Solution :

Value of goodwill = ₹ 7,00,000 + ₹ 9,00,000 = ₹ 16,00,000

Calculation of Sacrifice or Gain :

Old Ratio = 3 : 1

New Ratio = 5 : 3

Ram = $\frac{3}{4}-\frac{5}{8}=\frac{6-5}{8}=\frac{1}{8}$ (Sacrifice)

Ramesh = $\frac{1}{4}-\frac{3}{8}=\frac{2-3}{8}=\frac{1}{8}$ (Gain)

Since Ram has sacrificed, he will be credited by $\frac{1}{8}$ of ₹ 16,00,000 = ₹ 2,00,000

Since Ramesh has gained, he will be debited by $\frac{1}{8}$ of ₹ 16,00,000 = ₹ 2,00,000

Notes

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2013			
Jan. 1	Ramesh's Capital A/c Dr.	2,00,000	
	To Ram's Capital A/c		2,00,000
	(Adjustment for goodwill due to change in profit sharing ratio)		

23.5 REVALUATION OF ASSETS AND LIABILITIES

On admission of a new partner, the firm stands reconstituted and consequently the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner. If the values of the assets are raised, gain will increase the capital of the existing partners. Similarly, any decrease in the value of assets, i.e. loss will decrease the capital of the existing partners. For this purpose a'Revaluation Account' is prepared. This account is credited with all increases in the value of assets and decrease in the value of liabilities. It is debited with decrease on account of value of assets and increase in the value of liabilities. The balance of this account shows a gain or loss on revaluation which is transferred to the existing partner's capital account in existing profit sharing ratio.

Accounting for Revaluation of Assets and Liabilities when there is a Change in the Profit Sharing Ratio of Existing Partners

Assets and liabilities of a firm must also be revalued at the time of change in profit sharing ratio of existing partners. The reason is that the realisable or actual value of assets and liabilities may be different from those shown in the Balance Sheet. It is possible that with the passage of time some of the assets might have appreciated in value while the value of certain other assets might have decreased and no record has been made of such changes in the books of accounts. Similarly there may be some unrecorded assets & libilities that may have to be accounted for. Revaluation of assets and reassessments of liabilities becomes necessary because the change in the value of assets and liabilities belongs to the period to change in profit sharing ratio and hence must be shared by the partners in their old profit sharing ratio.

Revaluation of assets and reassessment of liabilities may be given effect to in two different ways :

(a) When revised values are to be recorded in the books, and

(b) When revised values are not to be recorded in the books.

When revised values are to be recorded in the books

In such a case revaluation of assets and reassessment of liabilities is done with the help of a new account called **'Revaluation Account'**. Sometimes this account is also called as **'Profit & Loss Adjustment A/c'**. If there is a loss due to revaluation, revaluation account is debited and if the revaluation results in a profit, the revaluation account is credited.

The following journal entries made for this purpose are:

(i) For increase in the value of assets:

Asset A/c Dr. (individually)

To Revaluation A/c

(ii) For decrease in the value of Asset

Revaluation A/c Dr. (individually)

To Asset A/c

[Decrease in the value of assets]

(iii) For increase in the value of Liabilities:

Revaluation A/c Dr. (individually)

To Liabilities A/c

[Increase in the value of Liabilities]

(iv) For decrease in the value of Liabilities:

Liabilities A/c Dr.

To Revaluation A/c

[Decrease in the value of Liabilities]

(v) For unrecorded Assets

Asset A/c [unrecorded] Dr.

To Revaluation A/c

[Unrecorded asset recorded at actual value]

(vi) For unrecorded Liability :

Revaluation A/c Dr.

To Liability A/c [unrecorded]

[Unrecorded Liability recorded at actual value]

Notes

(vii) For transfer of gain on revaluation:

Revaluation A/c Dr.

To Existing Partner's Capital/Current A/c

[Profit on revaluation transferred to capital account in existing ratio]

(viii) For transfer of loss on revaluation:

Existing Partner's Capital/Current A/c Dr.

To Revaluation A/c

[Loss on revaluation transferred to capital account in existing ratio]

(a) When revaluation account shows gain :

Revaluation A/c Dr.

To Partner's Capital A/c (Old Profit Sharing Ratio)

(Profit on revaluation credited to Partner's Capital A/c)

(b) Above entry is reversed when revaluation account shows loss :

Partners Capital A/cs (Old Profit Sharing Ratio) Dr.

To Revaluation A/c

(Loss on revaluation debited to Partner's Capital A/cs)

Proforma of Revaluation Account is given as under:

Revaluation Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Decrease in value of assets	....	By Increase in value of assets	....
To Increase in value of liabilities	....	By Decrease in value of liabilities	....
To Unrecorded liabilities	....	By Unrecorded assets	....
To Gain on Revaluation transferred to partner's capital accounts (in old ratio)	....	By Loss on Revalution transferred to partner's capital accounts (in old ratio)	....
	....		....

Illustration 26

P, Q and R are partners sharing profits and losses in the ratio of 3 : 3 : 2. Their balance sheet as on 31st March 2013 was as follows :

Liabilities		₹	*Assets*	₹
Sundry Creditors		2,40,000	Cash at Bank	3,70,000
General Reserve		3,60,000	Sundry Debtors	4,40,000
Capital Accounts :			Stock	12,00,000
P	20,00,000		Machinery	15,90,000
Q	15,00,000		Building	20,00,000
R	15,00,000	50,00,000		
		56,00,000		56,00,000

Partners decided that with effect from 1st April 2013, they would share profits and losses in the ratio of 4 : 3 : 2. It was agreed that :

i. Stock be valued at ₹ 11,00,000

ii. Machinery is to be depreciated by 10%.

iii. A provision for doubtful debts is to be made on debtors @5%.

iv. Building to be appreciated by 20%.

v. A liability for ₹ 25,000 included in sundry creditors is not likely to arise.

Partners agreed that the revised values are to be recorded in the books. They do not, however want to distribute the general reserve. You are required to pass journal enteries, prepare capital accounts of the partners and the revised balance sheet.

Solution :

Journal

Date	*Particulars*		*Dr.* (₹)	*Cr.* (₹)
	Revaluation A/c	Dr.	2,81,000	
	To Stock A/c			1,00,000
	To Machinery A/c			1,59,000
	To Provision for Doubtful Debts A/c			22,000
	(Decrease in the value of assets and provision made for doubtful debts)			
	Building A/c	Dr.	4,00,000	
	Sundry Creditors A/c	Dr.	25,000	
	To Revaluation A/c			4,25,000
	(Increase in the value of building and decrease in creditors)			

Notes

	Revaluation A/c Dr. (1)	1,44,000	
	To P's Capital A/c		54,000
	To Q's Capital A/c		54,000
	To R's Capital A/c		36,000
	(The transfer of gain on revaluation to the capital accounts of partners in old ratio)		
	P's Capital A/c Dr.(2)	25,000	
	To Q's Capital A/c		15,000
	To R's Capital A/c		10,000
	(The adjustment for general reserve on change in profit sharing ratio)		

Working Note :

(1) Revaluation Account

Particulars	₹	***Particulars***	₹
To Stock A/c	1,00,000	By Building A/c	4,00,000
To Machinery A/c	1,59,000	By Sundry Creditors A/c	25,000
To Provision for doubtful debts A/c	22,000		
To Gain on Revaluation transferred to :			
P's Capital A/c (3/8)	54,000		
Q's Capital A/c (3/8)	54,000		
R's Capital A/c (2/8)	36,000		
	4,25,000		4,25,000

(2) Adjustment for General Reserve :

Old Ratio of P, Q and R	3 : 3 : 2
New Ratio of P, Q and R	4 : 3 : 2

Sacrifice or Gain :

$$P = \frac{3}{8} - \frac{4}{9} = \frac{5}{72} \text{ (Gain)}$$

$$Q = \frac{3}{8} - \frac{3}{9} = \frac{3}{72} \text{ (Sacrifice)}$$

$$R = \frac{2}{8} - \frac{2}{9} = \frac{2}{72} \text{ (Sacrifice)}$$

Since P has gained, he will be debited for $\frac{5}{72}$ of General Reserve

or ₹ 3,60,000 = ₹ 25,000

Since Q has Sacrificed, he will be credited for $\frac{3}{72}$ of General Reserve

or ₹ 3,60,000 = ₹ 15,000

Since R has sacrificed, he will be credited for $\frac{2}{72}$ of General Reserve

or ₹ 3,60,000 = ₹ 10,000

Notes

Capital Accounts

Particulars	*P* ₹	*Q* ₹	*R* ₹	*Particulars*	*P* ₹	*Q* ₹	*R* ₹
To Q's Capital A/c	15,000			By Balance b/d	20,00,000	15,00,000	15,00,000
To R's Capital A/c	10,000			By Revaluation A/c	54,000	54,000	36,000
To Balance C/d	20,29,000	15,69,000	15,46,000	By P's Capital A/c		15,000	10,000
	20,54,000	15,69,000	15,46,000		20,54,000	15,69,000	15,46,000

Balance Sheet

as at 1st April 2013

Liabilities		₹	*Assets*		₹
Sundry Creditors		2,15,000	Cash at Bank		3,70,000
General Reserve		3,60,000	Sundry Debtors	4,40,000	
Capital Accounts :			***Less :*** Provision for		
P	20,29,000		doubtful debts	22,000	4,18,000
Q	15,69,000		Stock		11,00,000
R	15,46,600	51,44,000	Machinery		14,31,000
			Building		24,00,000
		57,19,000			57,19,000

Illustration 27

Ram, Mohan and Sohan are partners sharing profits and losses in the ratio of 3 : 2 : 1. Their balance sheet as at 31st December 2012 was as follows :

Liabilities		₹	*Assets*		₹
Creditors		8,700	Cash		3,000
Reserves		4,200	Debtors	6,200	
Profit & Loss A/c (Profits)		2,100	*Less:* Provision for		
Capital Accounts :			doubtful debts	200	6,000
Ram	30,000		Stock		18,000
Mohan	30,000		Furniture		3,000
Sohan	5,000	65,000	Plant		20,000
			Building		30,000
		80,000			80,000

The partners agreed that from 1st January 2013 they will share profits and losses in the ratio of 4 : 4 : 1. They agreed that :

i. Stock is to be valued at 20% less.

ii. Provision for doubtful debts to be increased by ₹ 150.

iii. Furniture is to be depreciated by 20% and plant by 15%.

iv. ₹ 350 are outstanding for salaries.

v. Building is to be valued at ₹ 35,000.

vi. Goodwill is valued at ₹ 4,500.

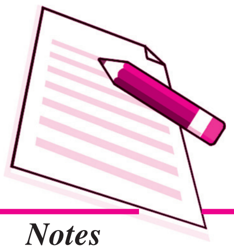
Partners do not want to record the altered values of assets and liabilities in the books and want to leave the reserves and profits undistributed. They also decided not to show goodwill in the books.

You are required to pass a single journal entry to give effect to the above. Also prepare the revised balance sheet.

Solution :

Workings :

Loss due to decrease in the value of Stock	3,600
Loss due to provision for doubtful debts	150
Loss due to decrease in the value of Furniture	600
Loss due to decrease in the value of Plant	3,000
Loss due to unrecorded liability (*i.e.* Outstanding salary)	350
	7,700


Notes

Gain due to increase in the value of Building	5,000
Loss on Revaluation	(-) 2,700
Adjustment for Reserves	(+) 4,200
Adjustment for Profit & Loss A/c (Profit)	(+) 2,100
Adjustment for Goodwill	(+) 4,500
Net Gain	(+) 8,100

Old Ratio of Ram, Mohan and Sohan 3 : 2 : 1

New Ratio of Ram, Mohan and Sohan 4 : 4 : 1

Sacrifice or Gain :

Ram $= \frac{3}{6} - \frac{4}{9} = \frac{1}{18}$ (Sacrifice) $8{,}100 \times \frac{1}{18}$ = ₹ 450 (Cr.)

Mohan $= \frac{2}{6} - \frac{4}{9} = \frac{2}{18}$ (Gain) $8{,}100 \times \frac{2}{18}$ = ₹ 900 (Dr.)

Sohan $= \frac{1}{6} - \frac{1}{9} = \frac{1}{18}$ (Sacrifice) $8{,}100 \times \frac{1}{18}$ = ₹ 450 (Cr.)

Journal

Date	*Particulars*	*Dr. (₹)*	*Cr. (₹)*
2013			
Jan. 1	Mohan's Capital A/c Dr.	900	
	To Ram's Capital A/c		450
	To Sohan Capital A/c		450
	(The adjustment for revaluation of assets and liabilities and for reserves, profits and goodwill on change in profit sharing ratio)		

Illustration 28

Saroj, Charu and Sangita are partners in a firm in the ratio of 5 : 4 : 2. On 1st April, 2014 they decided to share profits in future in the ratio of 4 : 3 : 2. On this date general reserve was ₹ 3,49,000 and loss on revaluation of assets and liabilities was ₹ 52,000. It was decided that adjustment should be made without altering the figures of assets and liabilities in the Balance Sheet. Make adjustment by a single journal entry.

Solution :

	₹
General Reserve	3,49,000
(-) Loss on Revaluation	52,000
Net amount of gain	2,97,000

Old Ratio of Saroj, Charu and Sangita 5 : 4 : 2

New Ratio of Saroj, Charu and Sangita 4 : 3 : 2

Sacrifice or Gain :

Saroj $= \frac{5}{11} - \frac{4}{9} = \frac{1}{99}$ (Sacrifice) $\quad 2,97,000 \times \frac{1}{99}$ = ₹ 3,000 (Cr.)

Charu $= \frac{4}{11} - \frac{3}{9} = \frac{3}{99}$ (Sacrifice) $\quad 2,97,000 \times \frac{3}{99}$ = ₹ 9,000 (Cr.)

Sangita $= \frac{2}{11} - \frac{2}{9} = \frac{4}{99}$ (Gain) $\quad 2,97,000 \times \frac{4}{99}$ = ₹ 12,000 (Dr.)

Journal

Date	*Particulars*	*Dr. (₹)*	*Cr. (₹)*
2014			
Apr. 1	Sangita's Capital A/c Dr.	12,000	
	To Saroj's Capital A/c		3,000
	To Charu Capital A/c		9,000
	(The adjustment for general reserve and loss on revaluation of assets and liabilities on change in profit sharing ratio)		

Illustration 29

A, B and C are partners sharing profits and losses in the ratio of 3 : 3 : 2. Their Balance Sheet as at 31st March, 2014 was as follows :

Liabilities		₹	*Assets*	₹
Sundry Creditors		2,400	Cash at Bank	3,700
General Reserve		3,600	Sundry Debtors	4,400
Capital Accounts :			Stock	12,000
A	20,000		Machinery	15,900

Notes

B	15,000		Building	20,000
C	15,000	50,000		
		56,000		56,000

Partners decided that with effect from 1st April, 2014 they would share profits and losses in the ratio of 4 : 3 : 2. It was agreed that :

i. Stock be valued at Rs. 11,000.

ii. Machinery is to be depreciated by 10%.

iii. A provision for doubtful debts is to be made on Debtors @5%.

iv. Building to be appreciated by 20%.

v. A liability for ₹ 250 included in Sundry Creditors is not likely to arise.

Partners agreed that the revised values are not to be recorded in the books. They also do not want to distribute the general reserve. You are required to pass Journal Entries, prepare Capital Account of the partners and the Balance Sheet.

Solution :

Journal

Date	*Particulars*	*Dr. (₹)*	*Cr. (₹)*
2014			
April 1	A's Capital Ac/ Dr.	350	
	To B's Capital A/c		210
	To C's Capital A/c		140
	(Being adjustment for revaluation of assets and liabilities and for general reserve made on change in profit-sharing ratio)		

Partners' Capital Accounts

Dr. Cr.

Particulars	*A*	*B*	*C*	*Particulars*	*A*	*B*	*C*
To B's Capital A/c	210	-----	------	By Balance b/d	20,000	15,000	15,000
To C's Capital A/c	140	-----	------	By A's Capital A/c	----	210	140
To Balance c/d	19,650	15,210	15,140				
	20,000	15,210	15,140		20,000	15,210	15,140

Balance Sheet
as at 1st April 2014

Liabilities		₹	*Assets*	₹
Sundry Creditors		2,400	Cash at Bank	3,700
General Reserve		3,600	Sundry Debtors	4,400
Capital Accounts :			Stock	12,000
A	19,650		Machinery	15,900
B	15,210		Building	20,000
C	15,140	50,000		
		56,000		56,000

Working Notes :

(1)

Particulars	₹	₹
Loss due to decrease in the value of Stock	1,000	
Loss due to decrease in the value of Machinery	1,590	
Loss due to Provision for Doubtful Debts	220	2,810
Gain due to increase in the value of Building	4,000	
Gain due to decrease in Sundry Creditors	250	4,250
Gain on Revaluation	1,440	
+ General Reserve	3,600	5,040

(2) Old Ratio of A, B and C 3 : 3 : 2

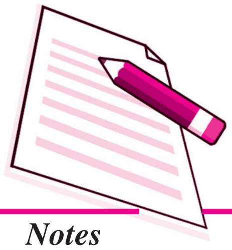
New Ratio of A, B and C 4 : 3 : 2

Sacrificing Ratio = Old Share - New Share

$A = \frac{3}{8} - \frac{4}{9} = \frac{5}{72}$ (Gain) ₹ $5{,}040 \times \frac{5}{72}$ = ₹ 350 (Dr.)

$B = \frac{3}{8} - \frac{3}{9} = \frac{3}{72}$ (Sacrifice) ₹ $5{,}040 \times \frac{3}{72}$ = ₹ 210 (Cr.)

$C = \frac{2}{8} - \frac{2}{9} = \frac{2}{72}$ (Sacrifice) ₹ $5{,}040 \times \frac{2}{72}$ = ₹ 140 (Cr.)



Notes

Illustration 30

Karan and Tarun are partners sharing profit and losses in the ratio of 2 : 1. Their Balance Sheet was as follows:

Balance Sheet of Karan and Tarun as at December 31,2014

Liabilities		₹	*Assets*	₹
Creditors		10,000	Cash in hand	7,000
Bills payable		7,000	Debtors	26,000
			Building	20,000
Capitals:			Investment	15,000
Karan	40,000		Machinery	13,000
Tarun	30,000	70,000	Stock	6,000
		87,000		87,000

Nikhil is admitted as a partner and assets are revalued and liabilities reassessed as follows:

(i) Create a Provision for doubtful debt on debtors at ₹ 800.

(ii) Building and investment are appreciated by 10%.

(iii) Machinery is depreciated at 5%

(iv) Creditors were overestimated by ₹ 500.

Make journal entries and Prepare revaluation account before the admission of Nikhil.

Solution :

Journal

Date	*Particulars*		*L.F.*	*Debit* (₹)	*Credit* (₹)
	Revaluation A/c	Dr.		800	
	To Provision for Doubtful Debts				800
	[Provision made for doubtful debts]				
	Building A/c	Dr.		2,000	
	Investment A/c	Dr.		1,500	
	To Revaluation A/c				3,500
	[Increase in the value of Building & Investment]				

Notes

	Revaluation A/c Dr. To Machinery A/c [Decrease in the value of machinery]		650	 650
	Creditors A/c Dr. To Revaluation A/c [Value of creditors reduced by ₹ 500]		500	 500

Revaluation account

Dr. Cr.

Particulars	₹	*Particulars*	₹
Provision for Doubtful Debts	800	Building	2,000
Machinery	650	Investment	1,500
Profit transferred to		Creditors	500
Karan's Capital 1,700			
Tarun's Capital 850	2,550		
	4,000		4,000

23.6 ADJUSTMENTS OF RESERVES AND ACCUMULATED PROFIT OR LOSSES

Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, is credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partner in the existing ratio. For this purpose the following journal entries are made:

(i) For distribution of undistributed profit and reserve.

Reserves A/c Dr
Profit & Loss A/c(Profit) Dr.
To Partner's Capital A/c [individually]
[Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio]

(ii) For distribution of loss

Partner's Capital A/c Dr. [individually]
ToProfit and Loss A/c [Loss]
[Profit & Loss (loss) transferred to all partners capitals A/c in existing profit sharing ratio]

Illustration 31

Rohit and Soniya are partners sharing profit in the ratio of 4:3. On lst April 2006 they admit Meena as a new partner for 1/4 share in profits. On that date the balance sheet of the firm shows a balance of ₹ 70,000 in general reserve and debit balance of Profit and Loss A/c of ₹ 21,000. make the necessary journal entries.

Solution :

Journal

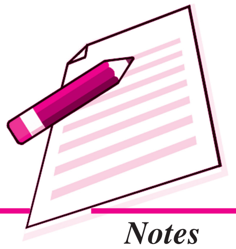
Date	Particulars		L.F.	Debit (₹)	Credit (₹)
	General Reserve	Dr		70,000	
	To Rohit's Capital A/c				40,000
	To Soniya's Capital A/c				30,000
	[Transfer of general reserve to the existing partner's capital accounts]				
	Rohit's Capital A/c	Dr.		12,000	
	Soniya's Capital A/c	Dr.		9,000	
	To Profit & Loss A/c				21000
	[Transfer of accumulated Loss to existing partner's capital A/c]				

Illustration : 32

Bhanu and Etika are partners sharing profit and losses in the ratio of 3:2 respectively. Their Balance Sheet as at March 31, 2014 was as under:

Balance Sheet of Bhanu and Etika as at December 31,2014

Particulars		₹	Particulars	₹
Creditors		28,000	Cash in hand	3,000
Capitals :			Cash at Bank	23,000
Bhanu	70,000		Debtors	19,000
Etika	70,000	1,40,000	Buildings	65,000
			Furniture	15,000
			Machinery	13,000
			Stock	30,000
		1,68,000		1,68,000



Notes

On that date, they admit Deepak into partnership for 1/3 share in future profit on the following terms:

(i) Furniture and stock are to be depreciated by 10%.

(ii) Building is appreciated by ₹ 20,000.

(iii) 5% provision is to be created on Debtors for doubtful debts.

(iv) Deepak is to bring in ₹ 50,000 as his capital and ₹ 30,000 as goodwill.

Make necessary ledger accounts and balance sheet of the new firm.

Solution :

Revaluation Account

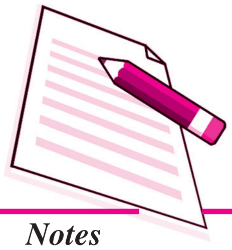
Dr. Cr.

Particulars	₹	*Particulars*	₹
Provision for Doubtful Debts	950	Building	20,000
Furniture	1,500		
Stock	3,000		
Profit transferred to			
Bhanu's Capital A/c 8,730			
Etika's Capital A/c 5,820	14,550		
	20,000		20,000

Capital Account

Dr. Cr.

Particulars	*Bhanu* (₹)	*Etika* (₹)	*Deepak* (₹)	*Particulars*	*Bhanu* (₹)	*Etika* (₹)	*Deepak* (₹)
Balance c/d (closing)	96,730	87,820	50,000	Balance b/d (closing)	70,000	70,000	—
				Revaluation (Profit)	8,730	5,820	—
				Bank A/c	—	—	50,000
				Goodwill Premium A/C	18,000	12,000	—
	96,730	87,820	50,000		96,730	87,820	50,000



Notes

Balance Sheet of Bhanu , Etika and Deepak
as on December 31, 2014

Liabilities		*Amount* (₹)	*Assets*		*Amount* (₹)
Creditors		28,000	Cash in hand		3,000
Capitals :			Cash at Bank		1,03,000
Bhanu	96,730		Debtors	19,000	
Etika	87,820		*Less:* Provision	950	18,050
Deepak	50,000	2,34,550	Stock		27,000
			Furniture		13,500
			Machinery		13,000
			Building		85,000
		2,62,550			2,62,550

Illustration 33

Ashu and Pankaj are partners sharing profit in the ratio of 3 : 2, their Balance sheet on March 31, 2014 was as follows:

Balance Sheet of Ashu and Pankaj
as at March 31,2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Creditors		38,000	Cash in hand	15,000
Bills Payable		40,000	Cash at Bank	62,000
Salaries outstanding		5,000	Debtors	58,000
Profit & Loss		40,000	Stock	85,000
Capitals:			Machinery	1,45,000
Ashu	1,50,000		Goodwill	38,000
Pankaj	1,30,000	2,80,000		
		4,03,000		4,03,000

They admitted Gurdeep into partnership on the following terms on March 31, 2014.

(a) New profit sharing ratio is agreed as 3 : 2 : 1.

Notes

(b) He will bring in ₹ 1,00,000 as his share of capital and ₹ 30,000 as his share of goodwill.

(c) Machinery is appreciated by 10%

(d) Stock is valued at ₹ 87,000.

(e) Creditors are unrecorded to the extent of ₹ 6,000.

(f) A provision for doubtful debts is to be created by 4% on debtors.

Prepare Revaluation account, Capital Accounts, Bank account and Balance Sheet of the new firm after admission of Gurdeep.

Solution :

Revaluation Account

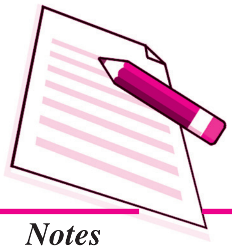
Dr. Cr.

Particulars	*(₹)*	*Particulars*	*(₹)*
Provision for Doubtful Debts	2,320	Machinery	14,500
Creditors	6,000	Stock	2,000
Profit transferred to			
Ashu's Capital A/c 4,908			
Pankaj's Capital A/c 3,272	8,180		
	16,500		16,500

Capital Account

Dr. Cr.

Particulars	*Ashu (₹)*	*Pankaj (₹)*	*Gurdeep (₹)*	*Particulars*	*Ashu (₹)*	*Pankaj (₹)*	*Gurdeep (₹)*
Goodwill A/c	22,800	15,200	—	Balance b/d	1,50,000	1,30,000	—
Balance c/d	1,74,108	1,46,072	1,00,000	Profit & Loss A/c	24,000	16,000	—
				Revaluation A/c (Profit)	4,908	3,272	
				Bank A/c	—	—	1,00,000
				Goodwill Premium A/c	18,000	12,000	—
	1,96,908	1,61,272	1,00,000		1,96,908	1,61,272	1,00,000



Notes

Balance Sheet of Ashu Pankaj and Gurdeep
as at March 31,2014

Liabilities		*Amount* (₹)	*Assets*		*Amount* (₹)
Creditors		44,000	Cash in hand		15,000
Bills Payable		40,000	Cash at Bank		1,92,000
Salaries outstanding		5,000	Debtors	58,000	
Capitals:			*Less:* Prov. of		
Ashu	1,74,108		doubtful debts (-)	2,320	55,680
Pankaj	1,46,072		Stock		87,000
Gurdeep	1,00,000	4,20,180	Machinery		1,59,500
		5,09,180			5,09,180

Bank Account

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Balance b/d	62,000	Balance c/d	1,92,000
Gurdeep's Capital A/c	1,00,000		
Goodwill A/c	30,000		
	1,92,000		1,92,000

Working Note:

Sacrificing Ratio = Existing Ratio – New Ratio

Partners	*Existing Ratio*	*New Ratio*	*Sacrifice*	*Sacrificing Ratio*
Ashu	3/5	3/6	$\frac{18-15}{30} = \frac{3}{30}$	Ashu : Pankaj
Pankaj	2/5	2/6		3 : 2

Illustration 34

Himani and Harsha are partners in a firm. Their Balance Sheet on March 31, 2014 was as follows:

Balance Sheet of Himani and Harsha
as at March 31,2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Provision for Doubtful Debts		3,000	Cash	20,000
Creditors		36,000	Sundry Debtors	90,000
Bills Payable		15,000	Stock	45,000
Outstanding Expenses		2,000	Machinery	41,000
Capitals:			Building	1,10,000
Himani	1,70,000		Goodwill	40,000
Harsha	1,20,000	2,90,000		
		3,46,000		3,46,000

On April 1, 2014 they admitted Charu as a Partner on the following terms:

(i) Charu brings ₹ 90,000 as her share of capital and she is unable to bring any amount for goodwill.

(ii) Goodwill is valued at 2 Years purchase of the average profit of last 4 years. The Profit of last 4 years amounted to ₹ 20,000; ₹ 30,000; ₹ 30,000; ₹ 40,000 Respectively.

(iii) New Profit sharing ratio between Himani's, Harsha's and Charu are 3 : 2 : 1.

(iv) Outstanding Expenses to be brought down to ₹ 500.

(v) The provision for doubtful debts is to be increased upto 5% on Debtors.

(vi) Machinery is depreciated by 10% and Stock is valued at ₹ 47,000.

Prepare Revaluation Account, Partners Capital account and opening Balance sheet of the New firm.

Solution:

Revaluation Account

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Provision for Doubtful Debts	1,500	Outstanding Expenses	1,500
Machinery	4,100	Stock	2,000

Notes

		Loss on revaluation transferred to :	
		Himani's Capital A/c 1,050	
		Harsha's Capital A/c 1,050	2,100
	5,600		5,600

Capital Account

Dr. Cr.

Particulars	*Himani* (₹)	*Harsha* (₹)	*Charu* (₹)	*Particulars*	*Himani* (₹)	*Harsha* (₹)	*Charu* (₹)
Goodwill A/c	20,000	20,000	—	Balance b/d	1,70,000	1,20,000	—
Revaluation A/c (loss)	1,050	1,050		Charu's Capital A/c	—	10,000	—
Harsha's Capital			10,000	Bank A/c	—	—	90,000
Balance c/d	1,48,950	1,08,950	80,000				
	1,70,000	1,30,000	90,000		1,70,000	1,30,000	90,000

Balance Sheet of Himani,Harsha and Charu
as at March 31,2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Provision for Doubtful Debts		4,500	Cash	70,000
			Bank	90,000
			Sundry Debtors	90,000
Creditors		36,000	Stock	47,000
Bills Payable		15,000	Machinery	36,900
Outstanding Expenses		500	Building	1,10,000
Capitals:				
Himani	1,48,950			
Harsha	1,08,950			
Charu	80,000	2,90,000		
		3,93,900		3,93,900

Working Note:

(i) Valuation of Goodwil l:

Total Profit = ₹ 20,000 + ₹ 30,000 + ₹ 30,000 + ₹ 40,000

Average Profit = ₹ 1,20,000/4 = ₹ 30,000

Goodwill = ₹ 30,000 × 2 = ₹ 60,000

Charu's Share of Goodwill = ₹ 60,000 × 1/6 = ₹ 10,000

(ii) Sacrificing Ratio = Existing Ratio – New Ratio

Himani's sacrifice = = 0

Harsha's sacrifice = $\frac{3-2}{6} = \frac{1}{6}$

Only Harsha sacrificed his share of profit.

INTEXT QUESTIONS 23.4

I. Fill in the blanks with suitable word/words :

i. Revaluation account is debited for an increase in the value of ....

ii. Revaluation account is credited for an increase in the value of ....

iii. Revaluation account is credited for an decrease in the value of ....

iv. Revaluation account is debited for an decrease in the value of ....

v. Profit on revaluation is transferred to the .... of the partners' capital account.

vi. Reserve should be distributed amongst the existing partners in ....

vii. Accumulated Losses are .... in the existing partner's capital account in existing profit sharing ratio.

II. Choose the correct option :

i. On change in the profit sharing ratio on the existing partners the accumulated profit will be transferred to the capital accout/current accounts of the existing partners in

a) Old Profit Sharing Ratio　　b) Equally
c) New Profit Sharing Ratio　　d) Gaining/Sacrificing Ratio

ii. On change in the profit sharing ratio of the existing partners the accumulated loss will be

a) debited to the capital accounts of the partners in old profit sharing ratio.

Notes

b) credited to the capital accounts of the partners in old profit sharing ratio.

c) debited to the capital accounts of the partners in new profit sharing ratio.

d) credited to the capital accounts of the partners in new profit sharing ratio.

iii. If profit sharing ratio of A & B is 3 : 2. They want to share profits equally. What is the sacrifice of A.

a) 1/10 b) 1/20 c) 1/15 d) 1/5

iv. If profit sharing ratio of A & B is 4 : 5. They agreed to share profit equally. What is the sacrifice of B.

a) 1/18 b) 1/10 c) 5/18 d) 7/18

v. If profit sharing ratio of A & B is 5 : 4. They agreed to share profit equally. What is the Gain of B.

a) 2/9 b) 1/18 c) 1/8 d) 4/9

III. State whether the revaluation account will be debited or credited on the revaluation of the following assets at the time of change in profit sharing ratio of the existing partners :

i. Increase in the value of land

ii. Increase in the value of stock

iii. Decrease in the value of machinery

iv. Decrease in the value of furniture.

IV. State whether the following statements are ture :

i. Revaluation account is credited on depreciation in machinery.

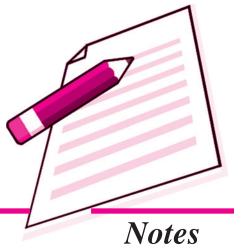
ii. Revaluation account is credited for depreciation in plant.

iii. Revaluation account is debited for the amount of provision for bad and doubtful debts.

iv. For recording the value of an unrecorded assets revaluation account is debited.

23.7 ADJUSTMENT OF PARTNER'S CAPITAL

Sometime, at the time of admission, the partners' agree that their capitals be adjusted in proportion to their profit sharing ratio. For this purpose, the capital accounts of



the existing partners are prepared, making all adjustments, on account of goodwill, general-reserve, revaluation of assets and resettlement of liabilities. The actual capital so adjusted will be compared with the amount of capital that should be kept in the business after the admission of the new partner. The excess if any, of adjusted actual capital over the proportionate capital will either be withdrawn or transferred to current account and vice versa.

The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital account balances.

1. Adjustment of existing partner's capital on the basis of the capital of the new partner :

If the capital of the new partner is given, the entire capital of the new firm will be determined on the basis of the new partner's capital and his profit sharing ratio. Therefore the capital of other partners is ascertained by dividing the total capital as per his profit sharing ratio.

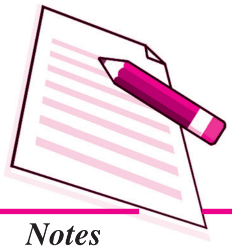
If the existing capital of the partner after adjustment is in excess of his new capital, the excess amount is withdrawn by partner or transferred to the credit of his current account. If the existing capital of the partner is less than his new capital, the partner brings the short amount or makes transfer to the debit of his current account. The journal entries are made as under:

(i) When excess amount is withdrawn by the partner or transferred to current account.

Existing Partner's Capital A/c Dr.
    To Bank A/c or Partner Current A/c
(Excess amount is withdrawn by the partner or transferred to current account)

(ii) For bringing in the Deficit amount or Balance transferred to current account.

Bank A/c or Partner Current A/c Dr.
    To Existing Partner's Capital A/c
(Bringing the Deficit amount or Balance transferred to current account)



Notes

Illustration 35

Asha and Boby are partners sharing profit in the ratio of 5:3 with capital of ₹80,000 and ₹ 70,000 respectively. They admit a new partner Nitin. The new profit sharing ratio of Asha, Boby and Nitin is 5:3:2 respectively. Nitin brings ₹40,000 as capital. The profit on revaluation of assets and reassessment of liabilities is ₹6,400. it is agreed that capitals of the partner's should be in the new profit sharing ratio. Calculate new capital of each partner.

Solution :

Actual Capital of Asha and Boby

	Asha (₹)	Boby (₹)
Balance in Capital A/c	80,000	70,000
Add Profit on Revaluation (5 : 3)	4,000	2,400
Capital after Adjustment	84,000	72,400

Calculation of new capital of the firm and existing partner's capital

Nitin's Share in the firm = 2/10

Nitin's brings ₹ 40,000 for 2/10 Share

Total capital of the new firm in terms of Nitin's capital = ₹40,000 × 10/2

= ₹ 2,00,000

Asha's share in New Capital = ₹ 2,00,000 × 5/10 = ₹ 1,00,000

Boby's share in New Capital = ₹ 2,00,000 × 3/10 = ₹ 60,000

On comparing Asha's adjusted capital with the new capital we find that the Asha brings ₹ 16,000 [₹ 1,00,000 - ₹ 84,000] or the amount may be debited to her current account.

On comparing the Boby's adjusted capital with the new capital, we find that the Boby is to withdraw ₹ 12,400 [₹ 72,400 - ₹ 60,000] or the amount may be credited to his current account.

2. When the capital of the new partner is calculated in proportion to the total capital of the new firm.

Notes

Sometimes the capital of the new partner is not given. He/she is required to bring an amount proportionate to his/her share of profit. In such a case, new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

For example, the capital accounts of Sumit and Anu show the balance after all adjustments and revaluation as ₹ 90,000 and ₹ 60,000 respectively. They admit Rohit as a new partner for 1/4 share in the profits. Rohit's capital is calculated as follows:

Total share = 1

Rohit's share in the profit = 1/4

Remaining share = 1 – 1/4 = 3/4

3/4 share of profit combined capital of Sumit and Anu

= ₹ 90,000 + ₹ 60,000 = ₹ 1,50,000

Total Capital of the firm = ₹ 1,50,000 × 4/3
= ₹ 2,00,000

Rohit's capital for 1/4 share of profits = ₹ 2,00,000 × 1/4 = ₹ 50,000

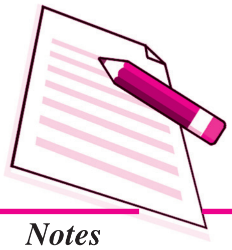
Rohit brings in ₹ 50,000 as his Capital

Illustration 36

Manoj and Hema are partner sharing profit and losses in the ratio of 7 : 3. On March 31, 2014, their Balance Sheet was as follows:

Balance Sheet of Manoj and Hema
as at March 31, 2014

Liabilities		*Amount (₹)*	*Assets*	*Amount (₹)*
Capital :			Bank	12,000
Manoj	88,000		Sundry Debtors	45,000
Hema	64,000	1,52,000	Bills Receivable	30,000
Sundry creditors		32,000	Stock	35,000
Bills Payable		38,000	Investment	13,000
Reserve		18,000	Machinery	40,000
			Building	45,000
			Goodwill	20,000
		2,40,000		2,40,000



Notes

They admit Tarun into partnership on the following terms:

(i) Stock is revalued at ₹ 40,000.

(ii) Building, Machinery and Investment are depreciated by 12%.

(iii) Prepaid Insurance is ₹ 1,000.

(iv) Tarun brings ₹ 40,000 as his capital and ₹ 12,000 for goodwill for 1/6 share of profit of the firm.

(v) Capital of the partners shall be proportionate to their profit sharing ratio. Adjustment of Capitals to be made by Cash.

Prepare Revaluation Account, Partners' Capital Account , Cash Account and Balance Sheet of the new firm.

Solution :

Revaluation Account

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*		*Amount (₹)*
Building	5,400	Stock		5,000
Machinery	4,800	Prepaid Insurance		1,000
Investment	1,560	Loss transferred to		
		Manoj's Capital	4,032	
		Hema's Capital	1,728	5,760
	11,760			11,760

Capital Account

Dr. Cr.

Particulars	*Manoj (₹)*	*Hema (₹)*	*Tarun (₹)*	*Particulars*	*Manoj (₹)*	*Hema (₹)*	*Tarun (₹)*
Goodwill	14,000	6,000		Balance b/d	88,000	64,000	
Revaluation A/c	4,032	1,728		Reserve	12,600	5,400	
(loss)				Goodwill A/c	8,400	3,600	
Bank A/c		5,272		Bank A/c	49,032		40,000
Balance c/d	1,40,000	60,000	40,000				
	1,58,032	73,000	90,000		1,58,032	73,000	90,000

Balance Sheet of Manoj, Hema and Tarun

as at March 31, 2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Bills Payable		38,000	Bank	1,07,760
Sundry creditors		32,000	Bills Receivable	30,000
Capitals A/c:			Sundry Debtors	45,000
Manoj	1,40,000		Stock	40,000
Hema	60,000		Investment	11,440
Tarun	40,000	2,40,000	Prepaid Insurance	1,000
			Machinery	35,200
			Building	39,600
		3,10,000		3,10,000

Bank Account

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Balance b/d	12,000	Hema's Capital A/c	5,272
Manoj's Capital A/c	49,032	Balance c/d	1,07,760
Goodwill A/c	12,000		
Tarun's Capital A/c	40,000		
	1,13,032		1,13,032

Working Note:

(a) Calculation of New profit Sharing Ratio:

Total Profit = 1

Tarun gets = 1/6

Remaining Profit = 1 – 1/6 = 5/6 shared by Manoj and Hema in their existing profit sharing ratio.

Manoj's new share = 5/6 × 7/10 = 7/12

Notes

Hema's new shares = 5/6 × 3/10 = 3/12

New profit sharing ratio of Manoj, Hema and Tarun

= 7/12 : 3/12 : 1/6 or 7 : 3 : 2.

(b) Adjustment of Capital:

Tarun brought capital for 1/6 share = ₹ 40,000

Total Capital of the firm = ₹ 40,000 × 6/1 = ₹ 2,40,000

Manoj's Capital = ₹ 2,40,000 × 7/12 = ₹ 1,40,000

Hema's Capital = ₹ 2,40,000 × 3/12 = ₹ 60,000

Tarun's Capital = ₹ 2,40,000 × 2/12 = ₹ 40,000

INTEXT QUESTIONS 23.5

Tanu and Anu are partner's sharing profit in the ratio 3:2. They admit Sumit as a new partner for 1/5 share in the profit and brings ₹50,000 for his capital. The Capital of Tanu and Anu after all the adjustments are ₹ 95,000 and ₹90,000 respectively. Calculate the total capital of the new firm and capital of each partner on the basis of the new partner's capital.

WHAT YOU HAVE LEARNT

- **Admission of a Partner – Meaning :** When a partner is admitted to the existing partnership firm, it is called admission of a partner.

  On the admission of a new partner, the following adjustments become necessary:

  (i) Adjustment in profit sharing ratio;

  (ii) Adjustment of Goodwill;

  (iii) Adjustment for revaluation of assets and reassessment of liabilities;

  (iv) Distribution of accumulated profits and reserves; and

  (v) Adjustment of partners' capitals.

- **Adjustment in Profit sharing Ratio :** When new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner.

Notes

- **Sacrificing Ratio :** At the time of admission of an incoming partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they surrender their profits is known as sacrificing ratio.
- **Meaning of Goodwill :** Any established firm develops wide business connections. This helps the firm to earn more profits as compared to a new firm. The monetary value of such advantage is known as "Goodwill".
- **Methods of valuation of Goodwill :** (i) Average Profit Method (ii) Super Profit Method (iii) Capitalisation Method
- **Revaluation of Assets and Liabilities :** On admission of a new partner, the firm is reconstituted and the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner.
- **Adjustments of Reserves and Accumulated Profit or Losses :** Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, are credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partners in the existing ratio.
- **Adjustment of Partner's Capital :** Sometimes, at the time of admission, the partners' agreed that their capitals are adjusted in proportionate to their profit sharing ratio. The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital accounts.
- At the time of change in profit sharing ratio of the existing partners the Reserves and accummulated profits/losses existing in the books are transferred to the capital/current accounts of the partners in their old profit sharing ratio.
- In case the partners decide to leave the reserves and profits/losses undistributed then an adjustment entry passed to give effect to the change in the profit sharing ratio. This is done by debiting the capital accounts of the partner(s) who have gained and crediting the capital accounts of the partners who have sacrificed proportionately.
- A change in profit sharing ratio of the existing partners implies that one partner is purchasing from another partner, a share of profit previously belonging to the latter. Therefore, the purchasing or gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill. The following journal entry is passed for treatment of goodwill on change in the profit sharing ratio of the existing partners.

Notes

Gaining Partners' Capital A/c Dr.
To Sacrificing partner's Capital A/c
(Treatment of goodwill on change in profit sharing ratio of exising partners)

- On change in profit sharing ratio of the existing partners it is desirable to revalue assets and reassess the liabilities. The reason is that the realisable value of assets may be different from the book value. Similarly the amount payable on account of third party liabilities may be different from the book value of the liabilities.
- Revaluation of assets and reassessment of liabilities may be given effect in two different ways : (a) When revised values are recorded in the books and; (b) When revised values are not recorded in the books.
- In the first case the revaluation is done by preparing Revaluation Account. Gain or Loss on revaluation is transferred to the capital accounts of the partners in their old profit sharing ratio.

TERMINAL EXERCISE

1. State the meaning of Sacrificing Ratio.
2. State the meaning of Goodwill.
3. Explain the methods of valuation of goodwill.
4. Explain 'Revaluation Account'. Why assets and liabilities are revalued at the time of admission of a new partner?
5. Explain the treatment of accumulated profit or losses and Reserves at the time of admission of a new partner.
6. Explain the calculation of the proportionate capital of the new partner in case of admission of a partner.
7. A and B are partners sharing profit in the ratio of 5 : 3 C is admitted to the partnership for 1/4 share of future profit . Calculate the new profit sharing ratio and sacrificing ratio.
8. Rohit and Meena are partners sharing profits and losses in the ratio of 7 : 3. Rohit surrenders 1/7 of his share and Meena surrenders 1/3 of her share in favour of Teena,a new partner. Calculate the new profit sharing ratio.

9. A firm has earned ₹3,00,000 as average profit for the last few years. Normal rate of return in the class of business is 15%. Find out goodwill according to Capitalisation of Super profit, if the value of net assets amounted to ₹16,00,000.

10. The following is the Balance Sheet of Tarun and Ashima sharing profit and losses in the ratio of 2 : 1.

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Capitals :			Cash	12,000
Tarun	50,000		Sundry Debtors	60,000
Ashima	40,000	90,000	Stock	12,000
Sundry creditors		20,000	Furniture	6,000
			Building	20,000
		1,10,000		1,10,000

They agreed to admit Sunita into partnership on the following terms:

(i) Sunita to pay ₹ 9,000 as Goodwill.

(ii) Sunita bring ₹ 11,000 as her Capital for 1/4 share of profit in the business.

(iii) Building and furniture to be depreciated at 5%. Stock is reduced by ₹ 1,600 and Bad Debt Reserve ₹ 1,300 to be provided for.

Prepare necessary ledge accounts and balance sheet after admission.

11. A and B are partner in a firm sharing profit in the ratio 2 : 1. C is admitted into the firm with 1/4 share in profits. He will bring in ₹ 60,000 as capital and capital of A and B are to be adjusted in the profit sharing ratio. The Balance sheet of A and B as on March 31, 2014 was as under:

Balance Sheet of A and B
as on March 31,2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Sundry creditors		16,000	Cash in Hand	4,000
Bills Payable		8,000	Cash at Bank	20,000
General Reserve		12,000	Sundry Debtors	16,000
Capitals:			Stock	20,000
A	1,00,000		Furniture	10,000

B	64,000	1,64,000	Machinery	50,000
			Building	80,000
		2,00,000		2,00,000

Notes

Other terms of agreement are as under:

i. C will bring in ₹ 24,000 as his share of Goodwill.

ii. Building was valued at ₹ 90,000 and Machinery at ₹ 46,000

iii. A provision for bad debts is to be created @ 6% on Debtors.

iv. The capital account of A and B are to be adjusted through cash.

Prepare necessary accounts and Balance Sheet after C's admission.

12. A and B were partners in a firm sharing profits in 3 : 2 ratio. From 1.4.2014 they decided to share profits equally. For this purpose the goodwill of the firm was valued at ₹ 50,000. Pass necessary adjustment entry for the treatment of goodwill due to change in profit sharing ratio between A and B.

13. X and Y were partners sharing profits in 5 : 3 ratio. From 1.1.2013 they decided to change the profit sharing ratio. The new ratio will be 3 : 5. For this purpose the goodwill of the firm was valued at ₹ 1,60,000. Pass necessary adjustment entry for treatment of goodwill on change in profit sharing of X and Y.

14. Alka, Jyoti and Sonam were partners sharing profits in 3 : 2 : 1 ratio. They decided to share the profits in future equally. For this purpose the goodwill of the firm was valued at ₹ 1,20,000.

    Pass necessary adjustment entry in the books of Alka, Jyoti and Sonam for the treatment of goodwill due to change in profit sharing ratio.

15. Akhil, Nikhil and Shakeel were partner in a firm sharing profits in 5:3:2 ratio. From 1.4.2014 they decided to share the profits in 3 : 5 : 2 ratio. For this purpose the goodwill of the firm was valued at ₹ 2,00,000.

    Pass the necessary journal entry for the treatment of goodwill on change in profit sharing ratio of Akhil, Nikhil and Shakeel.

16. Kumar and Janki were partners in a firm sharing profits in 3 : 2 ratio. On 31.3.2013 their balance sheet showed general reserve of ₹ 30,000. On that date they decided to share future profits equally.

    Pass necesary jorunal entry for the treatment of general reserve on the occassion of change in profit sharing ratio.

Notes

17. Ravi and Kanta were partners sharing profits in 3 : 1 ratio. On 31.3.2013 their books showed a debit balance of ₹ 40,000 of profit and loss account. They decided to share the profits in 3 : 2 ratio.

    Pass necessary journal entry for the treatment of the above balance.

18. Karan and Kartik were partners in a firm sharing profits in 3 : 2 ratio. Their balance sheet showed a general reserve of ₹ 15,000. They decided to share future profit in 3 : 1 ratio.

    Pass necessary journal entries for the treatment of general reserve on change in profit sharing ratio of Karan and Kartik.

19. Mamta, Jyoti and Ruchi were partners in a firm sharing profits in 3 : 2 : 1 ratio. They decided to share the future profits equally. At the time of change in profit sharing ratio they had a debit balance of ₹ 60,000 in their profit and loss account. They decided not to distribute the loss among themselves and give effect to the same by passing an adjustment entry.

20. P and Q were partners in a firm sharing profits in 3 : 4 ratio. They decided to share the profits equally from 1.4.2013. The following revaluation of assets and reassessment of liabilities was agreed upon between the partners on this occassion :

    i. Building was depreciation by ₹ 2,000.

    ii. A provision of 5% on debtors which were ₹ 10,000 was created for bad and doubtful debts.

    iii. Land was appreciated by ₹ 70,000.

    iv. Stock was depreciated by ₹ 30,000.

    Pass necessary journal entries for the above and prepare revaluation account.

21. Pass necessary journal entries and prepare revaluation account for the revaluation of the following items on change in profit sharing ratio of L and M from 2 : 3 to 4 : 5.

    i. There was an unrecorded Computer of ₹ 7,000 which was taken into account.

    ii. A creditor of ₹ 5,000 was not likely to be paid.

    iii. A piece of land purchased 5 years ago for ₹ 20,000 was valued at ₹2,00,000.

Notes

ANSWERS TO INTEXT QUESTIONS

23.1 I. (i) New, Existing (ii) Reconstituted
(iii) Sacrificing ratio (iv) Existing ratio

II. Sacrificing ratio 5 : 3.

23.2 I. (i) intangible (ii) incoming (iii) Normal Profit
(iv) Average profit, super profit and Capitalisation
(v) Outsider liabilities

II. (a) ₹ 62,500 (b) ₹ 1,25,000

23.3 I. (i) no entry (ii) credited (iii) sacrificing
(iv) debited (v) written off

II. 1. IV 2. III 3. I 4. II.

23.4 I. (i) Liabilities, (ii) Assets, (iii) Liabilities,
(iv) Assets, (v) Credit side (vi) Existing ratio
(vi) debited

II. (i) a (ii) a (iii) a (iv) a (v) b

III. (i) Credit (ii) Credit (iii) Debit (iv) Debit

IV. (i) False (ii) False (iii) True (iv) False

23.5 Total Capital of the new firm ₹ 2,50,000
Capital of Tanu's ₹ 1,20,000, capital of Anu's ₹ 80,000

ANSWERS TO TERMINAL EXERCISE

7. New profit sharing ratio 15 : 9 : 8, Sacrificing ratio 5 : 3.
8. New profit sharing ratio 3 : 1 : 1
9. Goodwill ₹ 4,00,000
10. Loss on Revaluation ₹ 4,200, Total of Balance Sheet ₹ 1,25,800
11. Profit on Revaluation ₹ 5,040, Capital of A ₹ 1,20,000, B & C ₹ 60,000 each, Balance sheet Total ₹ 2,64,000

ACTIVITY

Talk to the owners of five such business organisations which are doing good business and have built up good reputation in the market. Write against each firm the factor that have contributed to its goodwill

Name of the firm	*Nature of Business*	*Factors contributing to the goodwill of the firm*

Notes

24

RETIREMENT AND DEATH OF A PARTNER

If you look around, you must have noticed people in your relation and in your neighbourhood running business in partnership. You must have seen people quitting partnership firm or a person dies while in partnership. These are the events that take place during the lifetime of a partnership firm. Some issues arise on the happening of these events involving finance. Some assets and liabilities may need revaluation, goodwill is to be treated and amount of joint life policy is distributed and some accounting adjustment have to be made. Whenever such events take place, the firm has to calculate the dues of a partner leaving the firm or that of the deceased. In this lesson you will learn the accounting treatment in the books of the firm in these two cases i.e. retirement of a partner and death of a partner.

OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning of retirement/death of a partner;
- calculate new profit sharing ratio and gaining ratio;
- make adjustments relating to goodwill;
- explain the need for revaluation of assets and reassessment of liabilities at the time of retirement/death;
- describe treatment of accumulated reserves and undistributed profits at the time of retirement/death of a partner;

- prepare revaluation account on retirement/death of a partner;
- illustrate the various methods of settling the claim of retiring partner and the related accounting treatment;
- illustrate the accounting treatment of partners' capital and its adjustment;
- ascertain profit up to the date of death of a partner and
- prepare the account of the deceased partner's executor.

24.1 RETIREMENT – MEANING, CALCULATION OF NEW PROFIT SHARING RATIO AND GAINING RATIO

When one or more partners leave the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Amit, Sunil and Ashu are partners in a firm. Due to some family problems, Ashu wants to leave the firm. The other partners decide to allow him to withdraw from the partnership. Thus, due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement the retiring partner's claim is settled.

A partner retires either :

(i) with the consent of all partners, or

(ii) as per terms of the agreement; or

(iii) at his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. The old partnership comes to an end and a new partnership is formed among the remaining partners. At the time of retirement the following accounting issues are dealt with :

(a) New profit sharing ratio and gaining ratio.

(b) Goodwill.

(c) Adjustment of changes in the value of Assets and liabilities.

(d) Treatment of reserve and accumulated profits.

Notes

(e) Settlement of retiring partners dues.

(f) New capital of the continuing partners.

New Profit Sharing Ratio and Gaining Ratio

As soon as a partner retires the profit sharing ratio of the continuing partners get changed. The share of the retiring partner is distributed amongst the continuing partners. In the absence of information, the continuing partners take the retiring partner's share in their profit sharing ratio or in an agreed ratio. The ratio in which retiring partner's share is distributed amongst continuing partners is known as gaining ratio. Gain of a partner is

New Ratio – Existing Ratio

Gain of an exising partner = His New Share - His Existing (old) Share

Various cases of new ratio and gaining ratio are illustrated as follows :

(i) Retiring Partner's Share Distributed in Existing Ratio

In this case, retiring partner's share is distributed in existing ratio amongst the remaining partners. The remaining partners continue to share profits and losses in the existing ratio. The following example illustrates this :

Tanu, Manu and Rena are partners sharing profits and losses in the ratio of 4 : 3 : 2. Tanu retires and remaining partners decide to take Tanu's share in the existing ratio i.e. 3 : 2. Calculate the new ratio of Manu and Rena.

Existing Ratio between Manu and Rena = 3/9 and 2/9

Tanu's Share (retiring partner) = 4/9

Tanu's share taken by the Manu and Rena in the ratio of 3 : 2

Manu's Gain = $4/9 \times 3/5 = 12/45$

Manu's New Share = $3/9 + 12/45 = 27/45$

Rena's Gain = $4/9 \times 2/5 = 8/45$

Rena's New Share = $2/9 + 8/45 = 18/45$

New ratio of Manu and Rena is 27/45 : 18/45 = 27 : 18 = 3 : 2.

Gain of a Partner = New Share – Existing Share

Manu's Gain = 27/45 – 3/9 = 12/45

Rena's Gain = 18/45 – 2/9 = 8/45

Gaining Ratio = 12/45 : 8/45 OR 3 : 2

You may note that the new ratio is similar to existing ratio that existed between Manu and Rena before Tanu's retirement.

Note: In absence of any information in the question, it will be presumed that retiring partner's share has been distributed among the remaing partners in existing (old) ratio.

(ii) Retiring partner's share distributed in Specified proportion

Sometimes the remaining partners purchase the share of the retiring partner in specified ratio. The share purchased by them is added to their old share and the new ratio is arrived at. The following example illustrates this:

A, B and C are partners in the firm sharing profits in the ratio of 3 : 2 : 1. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.

B's Share = 2/6

B's share is divided between A and C in the ratio of 1 : 1.

A's Gain 1/2 of 2/6	= 2/6 × 1/2	= 1/6
A's New Share	= 3/6 + 1/6	= 4/6
C's Gain 1/2 of 2/6	= 2/6 × 1/2	= 1/6
C's New share	= 1/6+1/6	= 2/6

Thus new, ratio of A and C will be 2 : 1

(iii) Retiring Partner's share is taken by one of the partners

The retiring partner's share is taken up by one of the remaining partners. In this case, the retiring partner's share is added to that of existing partner's share. Only his/her share changes. The other partners continue to share profit in the existing ratio. An example illustrating this point is given below:

Anuj, Babu and Rani share profit in the ratio of 5 : 4 : 2. Babu retires and his share is taken by Rani, So Rani's share is 2/11 + 4/11 = 6/11, Anuj share will remain unchanged i.e, 5/11. Thus, the new profit sharing ratio of Anuj and Rani is 5 : 6.

Illustration 1

Neru, Anu and Ashu are partners sharing profit in the ratio of 4 : 3 : 2. Ashu retires. Find the new ratio of Neru and Anu if terms for retirement provide the following :

(i) Ratio is not given

(ii) Equal distribution of Ashu's share

(iii) Ashu's share is taken by Neru and Anu in the ratio of 2 : 1

(iv) Anu takes over the share of Ashu.

Solution :

(i) New profit sharing ratio of Neru and Anu is 4 : 3.

(ii) Ashu's share = 2/9

Neru's Gain = 1/2 of 2/9 = 2/9 × 1/2 = 1/9

Neru's New share = 4/9 + 1/9 = 5/9

Anu's Gain = 1/2 of 2/9 = 2/9 × 1/2 = 1/9

Anu's New Share = 3/9 + 1/9 = 4/9

New profit sharing ratio of Neru and Anu is 5/9 : 4/9 or 5 : 4

Gaining ratio is equal 1/9 : 1/9 = 1 : 1

(iii) Ashu's Share = 2/9

Neru's Gain = 2/3 of 2/9 = 2/9 × 2/3 = 4/27

Neru's new share = 4/9 + 4/27 = 16/27

Anu's Gain = 1/3 of 2/9 = 2/9 × 1/3 = 2/27

Anu's new share = 3/9 + 2/27 = 11/27

New profit sharing ratio of Neru and Anu is 16 : 11.

Gaining ratio is 4/27 : 2/27 = 4 : 2 = 2 : 1

$$\left[i.e. \frac{16}{27} - \frac{4}{9} = \frac{4}{27};\ \frac{11}{27} - \frac{3}{9} = \frac{2}{27};\ 4:2 = 2:1 \right]$$

(iv) Anu takes over Ashu share fully.

Ashu's share = 2/9

Anu's Gain = 2/9

Anu's new share = 3/9 + 2/9 = 5/9

New profit sharing ratio of Neru and Anu is 4 : 5

Only Anu gains.

Illustration 2

Ashish, Barmon, and Chander are partners sharing profits and losses in the ratio of 2 : 1 : 2 respectively. Chander retires and Ashish and Barman decide to share the profits and losses equally in future. Calculate the gaining ratio.

Solution :

Gain of a Partner	=	New Share – Existing (old) Share		
Hence, Ashish's Gain	=	1/2 – 2/5	=	1/10
Barman's Gain	=	1/2 – 1/5	=	3/10

Gaining ratio between Ashish and Barman is 1 : 3

INTEXT QUESTIONS 24.1

I. Give any three circumstances under which a partner may retire from partnership.

II. New share of remaining partner is

III. Gain of a Partners Share = New Share – ....?

IV. A B and C were sharing profit in the ratio of 3 : 2 : 1. A retires, his share is taken by B and C in the ratio of 2 : 1. Which of the following is the new ratio of B and C after A's retirement?

(a) 3 : 2 (b) 2 : 1 (c) 1 : 2

24.2 TREATMENT OF GOODWILL

The retiring partner is entitled to his/her share of goodwill at the time of retirement because the goodwill is the result of the efforts of all partners including the retiring one in the past. The retiring partner is compensated for his/her share of goodwill. As per Accounting Standard 10 (AS-10), goodwill is recorded in the books only when some consideration in money is paid for it. Therefore, goodwill is recorded in the books only when it is purchased and the goodwill account cannot be raised on its own.

Notes

Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is credited with. his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio. The journal entry is made as under:

Remaining Partners' Capital A/c Dr. (individually)
To Retiring Partner's Capital A/c
(Retiring partner's share of goodwill adjusted to remaining partners in the gaining ratio)

Illustration 3

Mitu, Udit and Sunny are partners sharing profit equally. Sunny retires and the goodwill of the firm is valued at ₹ 54,000. No goodwill account appears in the books of the firm. Mitu and Udit share future profit in the ratio of 3 : 2. Make necessary journal entry for goodwill.

Solution :

Journal

Date	*Particulars*	*L.F.*	*Debit Amount (₹)*	*Credit Amount (₹)*
	Mitu's Capital A/c Dr Udit's Capital A/c Dr. To Sunny's Capital A/c (Sunny's share of goodwill adjusted to remaining partners in their gaining ratio 4 : 1]		14,400 3,600	 18,000

Note : Sunny's share of goodwill = ₹ 54,000 × 1/3 = ₹18,000

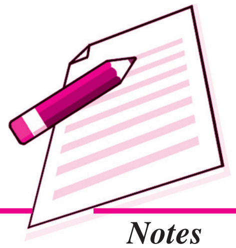
Gain of a Partner = New Share – Existing Share

Mitu Gains = 3/5 – 1/3 = 9/15 – 5/15 = 4/15

Udit Gains = 2/5 - 1/3 = 6/15 – 5/ 15 = 1/15

Gaining Ratio between Mitu and Udit = 4 : 1

When the Goodwill Account already appears in the Books



Notes

Normally the goodwill is not shown in the books of the firm. If at the time of retirement/ death of a partner, goodwill appears in the Balance Sheet of the firm, it will be written off by debiting all the partners' capital accounts in their existing profit sharing ratio and crediting the goodwill account. In such a case, the following journal entry is made:

Partners' Capital A/c Dr (including retiring partner's capital A/c)
To Goodwill A/c
(Existing goodwill written-off)

Illustration 4

Tanu, Priya and Mayank are partners' sharing profit in the ratio of 3 : 2 : 1. Priya retires and on the date of Priya's retirement goodwill is valued at ₹ 90,000. Goodwill already appears in the books at a value of ₹ 48,000. New ratio of Tanu and Mayank is 3 : 2. Make the necessary journal entries.

Solution :

Journal

Date	*Particulars*		*L.F.*	*Debit Amount (₹)*	*Credit Amount (₹)*
	Tanu's Capital A/c	Dr.		24,000	
	Priya's Capital A/c	Dr.		16,000	
	Mayank's Capital A/c	Dr.		8,000	
	To Goodwill A/c				48,000
	(Existing goodwill written-off from the books)				
	Tanu's Capital A/c	Dr.		9,000	
	Mayank's Capital A/c	Dr.		21,000	
	To Priya's Capital A/c				30,000
	(Priya's share of goodwill adjusted to remaining partners in their gaining ratio 3 : 7)				

Note : Priya's share of goodwill = ₹90,000 × 2/6 = ₹30,000

Gaining of a Partner's = New Share – Existing Share,

Notes

Tanu's Gain = 3/5 – 3/6 = 18/30 – 15/30 = 3/30

Mayank's Gain = 2/5 – 1/6 = 12/30 – 5/30 = 7/30

Gaining Ratio between Tanu and Mayank = 3 : 7

INTEXT QUESTIONS 24.2

State whether the following statements are True or False :

(i) Retiring partner's share of goodwill is debited to his/her capital account at the time of retirement.

(ii) Goodwill is recorded in the books only when it is purchased.

(iii) The retiring partner's capital account is debited with his/her share of goodwill and remaining partner's capital account is credited in their gaining ratio.

(iv) In case goodwill account is written off the capital account of all partners is credited.

24.3 REVALUATION OF ASSETS AND REASSESSMENT OF LIABILITIES

At the time of retirement of a partner the assets of the firm are revalued and liabilities are reassessed. Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner. Any gain or loss due to revaluation is divided amongst all the partners including retiring/deceased in their existing profit sharing ratio. Following journal entries are made for this purpose:

(i) For increase in value of assets:

Assets A/c	Dr.	(Individually)
To Revaluation A/c		
(Increase in the value of assets)		

(ii) For decrease in value of assets:

Revaluation A/c	Dr.	
To Assets A/c		(Individually)
(Decrease in the value of asset)		

(iii) For increase in value of Liabilities:

Revaluation A/c Dr.

To Liabilities A/c (Individually)

(Increase in the value of liabilities)

(iv) For decrease in value of Liabilities:

Liabilities A/c Dr. (Individually)

To Revaluation A/c

(Decrease in the value of liabilities)

Revaluation account is prepared to record the change in the value of assets or liabilities. It will reveal profit or loss on revaluation. This profit or loss is divided amongst all partners including the retiring/deceased partner in existing profit sharing ratio.

(v) For Profit on Revaluation :

Revaluation A/c Dr. (Individually)

To Partner's Capital A/c

(Profit on revaluation divided amongst all partners in their existing profit sharing ratio)

(vi) For loss on Revaluation:

Partner's Capital A/c Dr. (Individually)

To Revaluation A/c

(Loss on revaluation borne by all partners in their existing profit sharing ratio)

Illustration 5

Mudit, Mohit and Sonu are partners sharing profit in the ratio 3 : 2 : 1. Mudit retires from the partnership. In order to settle his claim, the following revaluation of assets and liabilities was agreed upon:

(i) The value of Machinery is increased by ₹ 25,000.

(ii) The value of Investment is increased by ₹ 2,000.

(iii) A provision for outstanding bill standing in the books at ₹ 1,000 is now not required.

(iv) The value of Land and Building is decreased by ₹ 12,000.

Give journal entries and prepare Revaluation account.

Notes

Solution :

JOURNAL

Date	*Particulars*		*L.F.*	*Debit Amount (₹)*	*Credit Amount (₹)*
	Machinery A/c	Dr.		25,000	
	Investments A/c	Dr.		2,000	
	Provision for Outstanding Bill	Dr.		1,000	
	To Revaluation A/c				28,000
	(Increase in value of Assets i.e. Machinery and investment and reduction in provision)				
	Revaluation A/c	Dr.		12,000	
	To Land and Building A/c				12,000
	(Decrease in value of assets)				
	Revaluation A/c	Dr.		16,000	
	To Mudit's Capital A/c				8,000
	To Mohit's Capital A/c				5,333
	To Sonu's Capital A/c				2,667
	(Gain on revaluation credited to all partners capital A/c in old profit sharing ratio i.e. 3 : 2 : 1)				

Revaluation Account

Dr. Cr.

Particulars		*Amount (₹)*	*Particulars*	*Amount (₹)*
Land and Building		12,000	Machinery	25,000
Profit transferred to :			Investments	2,000
Mudit Capital	8,000		Provision for Outstanding Bill	1,000
Mohit Capital	5,333			
Sonu Capital	2,667	16,000		
		28,000		28,000

24.4 TREATMENT OF ACCUMULATED RESERVES AND UNDISTRIBUTED PROFIT

All the balances of Accumulated Reserves, funds and undistributed amount of Profit or Loss appearing in the balance sheet of the firm on the date of retirement/death is distributed amongst all partners including retiring/deceased partner in their old profit sharing ratio, The following entries are made:

(i) For distribution of undistributed profit and reserve.

Reserves A/c	Dr	
Profit & Loss A/c (Profit)	Dr.	
To Partners' Capital A/c		(individually)
(Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio)		

(ii) For distribution of undistributed loss

Partners' Capital A/c	Dr.	(individually)
To Profit & Loss A/c (Loss)		
(Profit & Loss (loss) transferred to all partners Capitals A/c in old profit sharing ratio)		

INTEXT QUESTIONS 24.3

I. Fill in the blanks with suitable word or words :

(a) The credit balance of Revaluation account shows ....

(b) Reserve shown in the Balance sheet are transferred to the .... side of .... at the time of retirement of a partner.

(c) The value of the assets has decreased at the time of retirement of a Partner .... Account will be debited and .... account will be credited with the decrease in amount.

II. There was an increase in the value of a creditor at the time of retirement of a partner. What will be the journal entry for the above?

Notes

24.5 SETTLEMENT OF RETIRING PARTNER'S CLAIM

The amount due to the retiring partner is paid according to the terms of partnership agreement. The retiring partners' claim consists of

(a) The credit balance of Capital Account;

(b) His/her share in the Goodwill of the firm;

(c) His/her share in the Gain/Profit on Revaluation;

(d) His/her share in General Reserve and Accumulated Profit and

(f) Interest on Capital

But, the following deductions are made from the balance in his/her Capital Account on account :

(a) His/her share in the Loss on Revaluation;

(b) His/her Drawings and Interest on Drawings up to the date of retirement;

(c) His/her share of any accumulated losses and

(d) Loan taken from the firm.

The total amount so calculated is the claim of the retiring partner. He/she is interested in receiving the amount at the earliest. Total payment may be made immediately after his/her retirement. However, the resources of the firm may not be adequate to make the payment to the retiring partner in lumpsum. The firm makes payment to retiring partner in instalments.

(i) Payment in Lump Sum

Retiring partners' claim is paid either out of the funds available with the firm or out of funds brought in by the remaining partners.

The following journal entry is made for disposal of-the amount payable to the retiring partner :

On payment of cash in lump sum.

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

(Amount paid to the retiring partner)

Illustration 6

Om, Jai and Jagdish are partners sharing profit in the ratio of 3 : 2 : 1. Their balance sheet as at December 31st 2014 is as under :

Balance sheet as at December 31, 2014

Liabilities		*Amount* (₹)	*Assets*		*Amount* (₹)
Creditors		80,000	Building		1,80,000
Bills Payable		26,000	Plant		1,40,000
General reserve		24,000	Motor Car		40,000
Capital :			Stock		1,00,000
Om	1,60,000		Debtors	63,000	
Jai	1,20,000		*Less:* Provision		
Jagdish	1,20,000	4,00,000	for Bad debts	3,000	60,000
			Cash at Bank		10,000
		5,30,000			5,30,000

Jai retires on that date on the following terms:

(a) The Goodwill of the firm is valued at ₹ 60,000.

(b) Stock and Building to be appreciated by 10%.

(c) Plant is depreciated by 10%

(d) Provision for Bad debts is increased upto ₹ 5,000.

(e) Jai's share of goodwill was adjusted through remaining partners capital account,

The amount due to Jai is paid out of the fund brought in by Om and Jagdish in their new profit sharing ratio. Jai is paid full amount.

Prepare Revaluation Account and Partner's Capital account.

Solution :

It is assumed that Om and Jagdish gaining ratio remains 3 : 1.

Jai' Share of goodwill

₹ 60,000 × 2/6 = ₹ 20,000

Adjusted through the remaining partners capital account in 3 : 1 ratio

Notes

Revaluation Account

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Provision for Bad debts	2,000	Stock	10,000
Plant	14,000	Building	18,000
Profit transferred to			
Capital Accounts :			
Om 6,000			
Jai 4,000			
Jagdish 2,000	12,000		
	28,000		28,000

Capital Account

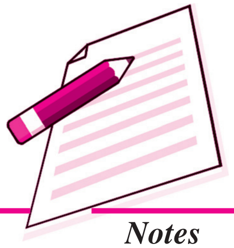
Dr. Cr.

Particulars	*Om* (₹)	*Jai* (₹)	*Jagdish* (₹)	*Particulars*	*Om* (₹)	*Jai* (₹)	*Jagdish* (₹)
Capital	15,000	—	5,000	Balance b/d	1,60,000	1,20,000	1,20,000
Bank		1,52,000		General Reserve	12,000	8,000	4,000
Balance c/d	2,77,000	—	1,59,000	Revaluation (Profit)	6,000	4,000	2,000
				Om Capital	—	15,000	—
				Jagdish Capital	—	5,000	
				Bank	1,14,000		38,000
	2,92000	1,52,000	164,000		2,92000	1,52,000	164,000

(ii) Payment in Instalments

In this case the amount due to retiring partner is paid in instalments. Usually, some amount is paid immediately on retirement and the balance is transferred to his loan account. This loan is paid in one or more instalments The loan amount carries some interest. In the absence of any agreement the rule under Section 37 of the Indian Partnership Act 1932 applies.

According to this rule, if the amount due to the retiring partner is not paid immediately on his retirement, he can claim interest @ 6% p.a. on the amount due.



Notes

An instalment consists of two parts :

(i) Principal Amount of instalment due to retiring partner.

(ii) Interest at an agreed rate,

Interest due on loan amount is credited to retiring partners' loan account. Instalment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.

(i) On part payment in cash and balance transferred to his/her loan account.

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

To Retiring Partner's Loan A/c

(Part payment made and balance transferred to loan A/c)

(ii) Total amount due transferred to loan A/c

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

(Total amount due transferred to loan A/c)

(iii) For interest due

Interest on loan A/c Dr.

To Retiring Partners' Loan A/c

(Interest due on loan)

(iv) For payment of instalment

Retiring Partners' Loan A/c

To Cash/Bank A/c

(Instalment inclusive of interest paid)

Illustration 7

Taking the figures of the previous illustration, assuming that he is paid 40% of the amount due immediately and the balance in three equal yearly instalments. The interest payable is 12% p.a.

Solution:

The amount due to Jai = ₹ 1,52,000

Amount paid immediately = ₹ 1,52,000 × 40/100 = ₹ 60,800

Amount of three equal instalments = ₹ 1,52,000 – ₹ 60,800 × 3

= ₹ 91,200 ÷ 3 = ₹ 30,400

1st Instalment at the end of 1st Year = ₹ 30,400 + ₹ 10,944 (interest)
= ₹ 41,344

Interest @ 12% pa. = ₹ 91,200 × 12/100 = ₹ 10,944

2nd Instalment at the end of 2nd Year = ₹ 30,400 + ₹ 7,296 (interest)
= ₹ 37,344

Interest @ 12% pa. = ₹ 60,800x12/ 100 = ₹ 7,296

3rd Instalment at the end of 3rd Year = ₹ 30,400 + ₹ 3,648
= ₹ 34,048

Interest @ 12% pa. = ₹ 30,400 × 12/100 = ₹ 3,648

INTEXT QUESTIONS 24.4

I. List the various claims of a retiring partner:

1. .... 2. .... 3. .... 4. ....

II. Mention the modes of settling the total claims of the retiring partner:

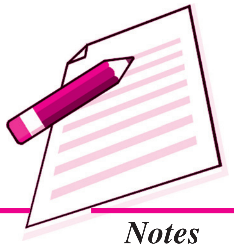
1. .... 2. ....

III. Find the total amount due to Munish, who is retiring as a partner:

1. Credit balance in Munish capital account ₹20,000.
2. Munish's share of goodwill ₹7,000
3. General reserve balance shown in Balance sheet ₹10,000
4. Profit on Revaluation of Assets /liabilities ₹ 3,000
5. Interest on drawings ₹ 1,500.
6. Munish share in the profit of the firm 1/2

24.6 ADJUSTMENT OF REMAINING PARTNER'S CAPITAL ACCOUNT AFTER RETIREMENT

After retirement of a partner the remaining partners may decide to adjust their capital. Often the remaining partners determine the total amount of capital of the reconstituted firm and decide to keep their respective capital accounts in proportion to the new profit sharing ratio. The total capital of the firm may be more or less than the total of their capital at the time of retirement. The new capitals of the partners are compared with the balance standing to the credit of respective partner's capital account. If there



Notes

is a surplus in the capital account, the amount is withdrawn by the concerned partner. The partner brings cash in case the balance in the capital account is less than the calculated amount.

Illustration 8

Roopa, Sunder and Shalu are partners sharing profit in the ratio of 5 : 3 : 2. Roopa retired, when their capitals were: ₹ 46,000, ₹ 42,000 and ₹38,000 respectively after making all adjustments on retirement. Sunder and Shalu decided to have a total capital of the firm at ₹ 84,000 in the proportion of 7 : 5. Calculate actual cash to be paid or brought in by each partner and make necessary journal entries.

Solution :

Total Capital of the New firm	= ₹ 84,000	
Sunder's share in the new capital	= ₹ 84,000 × 7/12	= ₹ 49,000
Shalu's share in the new capital	= ₹ 84,000 × 5/12	= ₹ 35,000

On comparing Sunder's share in the new capital of the firm with the amount standing to the credit of his capital, it is observed that he has to bring ₹ 7,000 the deficit amount (₹ 49,000 – ₹ 42,000) in Cash.

Similarly, Shalu's share in the new capital of the firm is ₹ 35,000 while ₹ 38,000 stand credited to her capital account. So she will withdraw ₹ 3,000, the surplus amount (₹ 38,000 – ₹ 35,000) from the firm so as to make her capital in proportion to their new profit share ratio.

Journal

Date	*Particulars*	*L.F.*	*Debit Amount (₹)*	*Credit Amount (₹)*
	Bank A/c Dr. To Sunder's Capital A/c (The deficit amount brought in by the partner)		7,000	 7,000
	Shalu's Capital A/c Dr. To Bank A/c (The surplus amount withdrawn by the partner)		3,000	 3,000

Adjustment of remaining partner's capital in their profit sharing ratio, when the total capital of the new firm is not pre-determined.

In this case the total amount of adjusted capital of the remaining partners is rearranged as per agreed proportion in which they share profit of the reconstituted firm. The following steps may be adopted:

(i) Add the balance standing to the credit of the remaining partners' capital accounts.

(ii) The total so obtained is the total capital of the firm.

(iii) This capital is divided according to the new profit sharing ratio.

Illustration 9

Sumit, Amit and Neha are partners sharing profit in the ratio of 4 : 3 : 1. when Amit retired , their adjusted capitals were ₹ 76,000; ₹ 45,000 and ₹ 34,000 respectively. Sumit and Neha decided to have their total capital of the firm in the ratio of 3 : 2. The necessary adjustments were to be made in cash only. Calculate actual cash to be paid off or brought in by each partner.

Solution:

Total of the adjusted capitals of the remaining partners.

Sumit	=	₹ 76,000
Neha	=	₹ 34,000
Total	=	₹ 110,000

Total capital of the firm which is divided in the new ratio of 3 : 2.

New capital of Sumit = ₹ 1,10,000 × 3/5 = ₹ 66,000

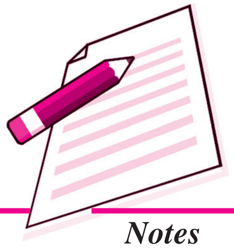
New Capital of Neha = ₹ 1,10,000 × 2/5 = ₹ 44,000

Sumit's share in the new capital of the firm is ₹ 66,000 while ₹ 76,000 stand credited to his capital account. So he will withdraw ₹ 10,000 (₹ 76,000 – ₹ 66,000) from the firm so as to make his capital in proportion to his new profit sharing ratio.

Similarly, Neha's share in the new capital of the firm is ₹ 44,000 while ₹ 34,000 stands credited to her capital account, She has to bring ₹ 10,000 (₹ 44,000 – ₹34,000) in Cash to make up the deficit in the capital account.

Illustration 10

The Balance Sheet of Rohit, Nisha and Sunil who are partners in a firm sharing profits according to their capitals as on 31st March 2014 was as under:



Notes

Liabilities		Amount (₹)	Assets		Amount (₹)
Creditors		25,000	Machinery		40,000
Bills Payable		13,000	Building		90,000
General Reserve		22,000	Debtors	30,000	
Capital :			Less Provision for		
Rohit	60,000		Bad debts	1,000	29,000
Nisha	40,000		Stocks		23,000
Sunil	40,000	1,40,000	Cash at Bank		18,000
		2,00,000			2,00,000

On the date of Balance Sheet, Nisha retired from the firm, and following adjustments were made:

(i) Building is appreciated by 20%.

(ii) Provision for bad debts is increased to 5% on Debtors.

(iii) Machinery is depreciated by 10%.

(iv) Goodwill of the firm is valued at ₹ 56,000 and the retiring partner's share is adjusted.

(v) The capital of the new firm is fixed at ₹ 1,20,000.

Prepare Revaluation Account, Capital Accounts of the partner and Balance Sheet of the new firm after Nisha's retirement.

Solution :

Revaluation Account

Dr. Cr.

Particulars		Amount (₹)	Particulars	Amount (₹)
Provision for Bad debt A/c		500	Building A/c	18,000
Machinery A/c		4,000		
Profit transferred to				
Capital Accounts (3 : 2 : 2)				
Rohit	5,786			
Nisha	3,857			
Sunil	3,857	13,500		
		18,000		18,000

Capital Account

Dr. Cr.

Particulars	*Rohit* (₹)	*Nisha* (₹)	*Sunil* (₹)	*Particulars*	*Rohit* (₹)	*Nisha* (₹)	*Sunil* (₹)
Sunil's Capital a/c	9,600	—	6,400	Balance b/d	60,000	40,000	40,000
Bank		66,143		General Reserve	9,428	6,286	6,286
Balance c/d	72,000	—	48,000	Revaluation (Profit)	5,786	3,857	3,857
				Rohit's Capital A/c	—	9,600	—
				Sunil's Capital A/c		6,400	
				Bank	6,386		4,257
	81,600	66,143	54,400		81,600	66,143	54,400

Balance Sheet as at 31st March 2014

Liabilities		*Amount* (₹)	*Assets*		*Amount* (₹)
Creditors		25,000	Building		1,08,000
Bank overdraft		37,500	Machinery		36,000
Bills Payable		13,000	Debtors	30,000	
Capital:			*Less:* Provision		
Rohit	72,000		for Bad debts	1,500	28,500
Sunil	48,000	1,20,000	Stock		23,000
		1,95,500			1,95,500

Working Notes :

(i) (a) Profit sharing ratio is 60,000 : 40,000 : 40,000 i.e. = 3 : 2 : 2

(b) Gaining Ratio: Rohit = 3/5 – 3/7 = 21/35 – 15/35 = 6/35

Sunil = 2/5-2/7 = 14/35 – 10/35 = 4/35

= 6/35 : 4/35

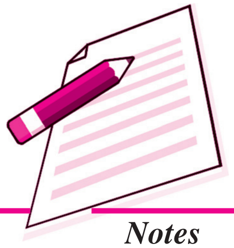
= 6 : 4 = 3 : 2

(c) Nisha Share of Goodwill = ₹ 56,000 × 2/7 = ₹ 16,000.

Share of Goodwill in the gaining ratio by the existing partner, i.e.

Rohit = ₹ 16,000 × 3/5 = ₹ 9,600

Sunil = ₹ 16,000 × 2/5 = ₹ 6,400



The journal entry is

		₹	₹
Rohit's Capital A/c	Dr.	9,600	
Sunil's Capital A/c	Dr.	6,400	
To Nisha's Capital A/c			16,000
(Share of Goodwill divided into gaining ratio)			

Bank Account

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
Balance b/d	18,000	Nisha's Capital A/c	66,143
Rohit's Capital A/c	6,386		
Sunil's Capital A/c	4,257		
Balance c/d (Bank overdraft)	37,500		
	66,143		66,143

(ii) Bank overdraft is taken to pay the retiring partners amount.

(iii) New Capital of the firm is fixed at ₹ 1,20,000.

	Rohit (₹)	*Sunil (₹)*
New Capital (₹1,20,000 in the ratio of 3 : 2)	72,000	48,000
Existing Capital (After Adjustments) i.e. partner capitals	65,614	43,743
Cash to be brought by the remaining partners	6.386	4,257

Illustration 11

Chauhan Triphati and Gupta are partners in a firm sharing profit and losses in the ratio of 1/2, 1/6 and 1/3 respectively. The Balance Sheet on March 31, 2014 was as follows :

Liabilities	*Amount (₹)*	*Assets*	*Amount (₹)*
Sundry Creditors	36,000	Freehold Premises	80,000
Bills Payable	24,000	Machinery	60,000

Notes

General Reserve		24,000	Furniture		24,000
Capitals:			Debtors	40000	
Chauhan	60,000		*Less :* Provision		
Triphati	60,000		for bad debts	2,000	38,000
Gupta	56,000	1,76,000	Stock		44,000
			Cash		14,000
		2,60,000			2,60,000

Gupta retires from the business and the partners agree to the following revaluation:

(a) Freehold premises and stock are to be appreciated by 20% and 15%. respectively

(b) Machinery and furniture are to be depreciated by 10% and 7% respectively

(c) Bad debts reserve is to be increased to ₹ 3,000.

(d) On Gupta's retirement, the goodwill is valued at ₹ 42,000.

(e) The remaining partners have decided to adjust their capitals in their new profit sharing ratio after retirement of Gupta. Surplus/deficit, if any in their capital account will be adjusted through cash.

Prepare necessary ledger accounts and Balance Sheet of reconstituted firm.

Solution:

Revaluation Account

Dr. Cr.

Particulars		*Amount (₹)*	*Particulars*	*Amount (₹)*
Provision for Bad debts		1,000	Freehold Premises	16,000
Machinery		6,000	Stock	6,600
Furniture		1,680		
Profit transferred to				
Capital Accounts:				
Chauhan	6,960			
Triphati	2,320			
Gupta	4,640	13,920		
		22,600		22,600

Notes

Capital Account

Dr. Cr.

Particulars	Chauhan (₹)	Triphati (₹)	Gupta (₹)	Particulars	Chauhan (₹)	Triphati (₹)	Gupta (₹)
Gupta Capital	10,500	3,500		Balance b/d	60,000	60,000	56,000
Gupta Loan			82,640	General Reserve	12,009	4,000	8,000
Cash		30,000		Revaluation (Profit)	6,960	2,320	4,640
Balance c/d	98,460	32,820		Chauhan Capital			10,500
				Tirphati Capital			3,500
				Cash	30,000		
	1,08,960	66,320	82,640		1,08,960	66,320	82,640

Balance Sheet as at March 31, 2014

Liabilities		Amount (₹)	Assets		Amount (₹)
Creditors		36,000	Freehold Premises		96,000
Bills Payable		24,000	Machinery		54,000
Gupta's Loan		82,640	Furniture		22,320
Capital:			Debtors	40,000	
Chauhan	98,460		*Less :* Provision		
Tirphati	32,820	1,31,280	for bad debts	3,000	37,000
			Stock		50,600
			Cash		14,000
		2,73,920			2,73,920

Working Note:

(a) In the absence of agreement, retiring partner's capital account is transferred to his loan account.

(b) In the absence of agreement, gaining ratio is equal to existing ratio (old ratio) of remaining partners is gaining ratio i.e. 3 : 1

(c) Calculation of Cash brought in (or paid off) by remaining partner.

	Chauhan ₹	Tirphati ₹
Total Capital of Chauhan and Tirphati (₹68,460 + ₹62,820 = ₹1,31,280 in the ratio of 3 : 1)	98,460	32,820
Adjusted existing Capital	68,460	62,820
Excess or Deficit	30,000 (Excess)	30,000 (Deficit)

Notes

INTEXT QUESTIONS 24.5

i. Surinder, Mahinder and Tarun are partners in a firm. After Surinder's retirernent, the profit sharing ratio between Mahinder and Tarun is 5 : 3.

They decide to fix the firm's capital at ₹ 80,000. Find the individual capitals of Mahinder and Tarun.

Mahinder's Capital ₹ .... Tarun's Capitals ₹ ....

ii. Sohan, Amisha and Neena are partners sharing profit in the ratio of 3 : 2 : 1. when Sohan retired, their adjusted capitals were ₹ 90,000, ₹ 60,000 and ₹ 70,000 respectively. Amisha and Neena decided to have their total capital of the firm in the ratio of 5 : 3. Find the capital of each partner and the total capital of firm.

Amisha Capital ₹ .... Neena Capital ₹ ....

24.7 DEATH OF A PARTNER

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner. On the death of partner the amount payable to him/her is paid to his/her legal representatives. The legal representatives are entitled to the followings :

(a) The amount standing to the credit of the capital account of the deceased partner.

(b) Interest on capital, if provided in the partnership deed upto the date of death.

(c) Share of goodwill of the firm.

(d) Share of undistributed profit or reserves.

(e) Share of profit on the revaluation of assets and liabilities.

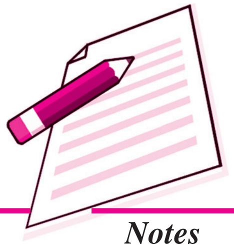
(f) Share of profit upto the date of death.

(g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives:

(i) Drawings

(ii) Interest on drawings



Notes

(iii) Share of loss on the revaluation of assets and liabilities;

(iv) Share of loss that have occurred till the date of his/her death.

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor.

The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment.

Calculation of Profit upto the Date of Death of a Partner

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods:

(i) Time Basis; (ii) Turnover or Sales Basis

(i) Time Basis

In this case, it is assumed that profit has been earned uniformly through out the year. For example:

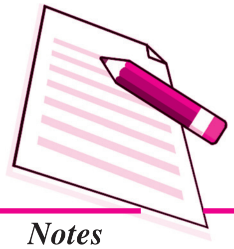
The total profit of previous year is ₹ 2,25,000 and a partner dies three months after the close of previous year, the profit of three months is ₹ 31,250 i.e. ₹ 1,25,000 × 3/12. If the deceased partner took 2/10 share of profit, his/her share of profit till the date of death is ₹ 6,250 i.e. ₹ 31,250 × 2/10

(ii) Turnover or Sales Basis

In this method, we have to take into consideration the profit and the total sales of the last year. Thereafter the profit upto the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

Illustration 12

Arun, Tarun and Neha are partners sharing profits in the ratio of 3 : 2 : 1 Neha dies on 31st May 2014. Sales for the year 2013-2014 amounted to ₹ 4,00,000 and the profit on sales is ₹ 60,000. Accounts are closed on 31 March every year. Sales from lst April 2014 to 31st May 2014 is ₹ 1,00,000.


Notes

Calculate the deceased partner's share in the profit upto the date of death.

Solution :

Profit from 1st April 2014 to 31st May 2014 on the basis of sales:

If sales are ₹ 4,00,000, profit is ₹ 60,000

If the sales are ₹ 1,00,000 profit is : ₹ 60,000/₹ 4,00,000 × ₹ 1,00,000

= ₹15,000

Neha's share = ₹ 15,000 × 1/6 = ₹ 2,500

Alternatively profit is calculated as

$$\text{Rate of profit} = \frac{60{,}000}{4{,}00{,}000} \times 100 = 15\%$$

Sale upto date of death = 1,00,000

$$\text{Profit} = 1{,}00{,}000 \times \frac{15}{100} = ₹\ 15000$$

Illustration 13

Nutan, Sumit and Shiba are partners in a firm sharing profits in the ratio 5 : 3 : 2. On 31st December 2014 their Balance Sheet was as under:

Liabilities		*Amount (₹)*	*Assets*	*Amount (₹)*
Creditors		52,000	Building	60,000
Reserve Fund		15,000	Plant	50,000
Capitals :			Stock	27,000
Nutan	60,000		Debtors	25,000
Sumit	45,000		Cash	10,000
Shiba	30,000	1,35,000	Bank	30,000
		2,02,000		2,02,000

Nutan died on 1 July 2015. It was agreed between her executor and the remaining partners that:

(i) Goodwill to be valued at 2½ years purchase of the average profits of the last Four years, which were: 2011 ₹ 25,000; 2012 ₹ 20,000; 2013 ₹40,000 and 2014 ₹35,000.

(ii) Building is valued at ₹ 70,000; Plant at ₹46,000 and Stock at ₹ 32,000.

(iii) Profit for the year 2015 be taken as having accrued at the same rate as that of the previous year.

(iv) Interest on capital is provided at 9% p.a.

(v) On 1 July 2015 her drawings account showed a balance of ₹.20,000.

(vi) ₹ 25,950 are to be paid immediately to her executor and the balance is transferred to her Executors Loan Account.

Prepare Nutan's Capital Account and Nutan's Executor's Account as on 1st July 2015.

Solution :

(i) Valuation of Goodwill:

Total Profit = ₹ 25,000 + ₹ 20,000 + ₹ 40,000 + ₹ 35,000

= ₹ 1,20,000

Average Profit = ₹ 1,20,000/4 = ₹ 30,000

Hence, Goodwill at 2½ year's purchase = ₹ 30,000 × 2½ = ₹ 75,000

Nutan's share of goodwill = ₹ 75,000 × 5/10 = ₹ 37,500

It is adjusted into the Capital Accounts of Sumit and Shiba in the gaining ratio of 3 : 2 i.e. ₹ 22,500 and ₹ 15000 respectively.

(ii) Share of Profit payable to Nutan [upto the date of death]

= ₹ 35,000 × 6/12 × 5/10

= ₹ 8,750

(iii) Nutan's Share of Reserve Fund = ₹ 15,000 × 5/10

= ₹ 7,500

(iv) Interest on Nutan's Capital = ₹ 60,000 × 9/100 × 6/12

= ₹ 2,700

Revaluation Account

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
Plant	4,000	Building	10,000

Notes

Profit transferred to		Stock	5,000
Nutan Capital 5,500			
Sumit Capital 3,300			
Shiba Capital 2,200	11,000		
	15,000		15,000

Nutan's Capital Account

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
Drawings	20,000	Balance b/d	60,000
Nutan's Executor's	1,01,950	Reserve fund	7,500
		Sumit's Capital (Goodwill)	15,000
		Shiba's Capital (Goodwill)	22,500
		Profit & Loss (Suspense)	8,750
		Revaluation A/c	5,500
		Interest on Capital	2,700
	1,21,950		1,21,950

Nutan's Executor's Accounts

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹*
Bank	25,950	Nutan's Capital	1,01,950
Nutan's Executor's Loan A/c (Transfer)	76,000		
	1,01,950		1,01,950

INTEXT QUESTIONS 24.6

Fill in the blanks with suitable words :

i. The Executor is entitled to all the rights of a ....

ii. Share of goodwill of the deceased partner is .... to his capital account.

iii. In case of death of a partner, the profit may be estimated on the basis of .... and ....

iv. The balance in the capital account of the deceased partner is transferred to his .... account.

v. Interest on drawing due from deceased partner till the date of the death is .... to his capital account.

Notes

WHAT YOU HAVE LEARNT

- **Retirement**

1. Due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions.

2. At the time of retirement the following accounting issues are dealt:
   (a) New profit sharing ratio and gaining ratio.
   (b) Goodwill
   (c) Adjustment of changes in the value of Assets and liabilities
   (d) Treatment of reserve and accumulated profits.
   (e) Settlement of retiring partner's dues,
   (f) New capital of the continuing partners.

- **Death**

1. On the death of a partner, the amount payable to him is paid to his/her legal representatives.

2. The representatives of deceased partner is entitled to the followings:
   (a) The amount standing to the credit of the capital account of the deceased partner.
   (b) Interest on capital, if provided in the partnership deed, upto the date of death.
   (c) Share of the value of goodwill of the firm.
   (d) Share of undistributed profit or reserves.

Notes

(e) Share of profit on the revaluation of assets and liabilities.

(f) Share of profit upto the date of death.

(g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives:

(i) Drawings

(ii) Interest on drawings

(iii) Share of loss on the revaluation of assets and liabilities

(iv) Share of loss that have occurred till the date of his/her death

3. Calculation of Profit upto the date of death Two Methods

(i) Time basis

(ii) Sales basis

TERMINAL EXERCISE

1. What is meant by retirement of a partner?
2. Explain the meaning of gaining Ratio.
3. Explain the accounting treatment of goodwill on retirement of a partner.
4. What problems involving finance arise when a partner dies? How would you deal with them as an accountant?
5. Seema, Mohit and Meenakshi were partners in a firm sharing profit in the ratio of 7 : 6 : 7. Mohit retired and his share was divided equally between Seema and Meenakshi. Calculate the new profit sharing ratio of Seema and Meenakshi.
6. Ashu, Ashmita and Meetu are partners sharing profits in the ratio of 4 : 3 : 2. Ashu retires, assuming Ashmita and Meetu will share profits in future in the ratio 5 : 3, determine the gaining ratio.
7. Anu, Beena and Chander are partners in a firm, sharing profit in the ratio of 3 : 2 : 1. Their Balance Sheet as on March 31, 2014 was as follows:

Liabilities	*Amount (₹)*	*Assets*	*Amount (₹)*
Sundry Creditors	3,200	Cash in hand	1,200
General Reserve	12,000	Cash at Bank	2,000

Capitals:			Debtors	18,000
Anu	20,000		Stocks	14,000
Beena	20,000		Machinery	12,000
Chander	20,000	60,000	Building	28,000
		75,200		75,200

On the date of Balance Sheet Chander retires from firm. It is agreed to adjust the value of assets as follows:

(a) Provide a reserve of 5% on Sundry Debtors for Doubtful Debts.

(b) Building to be revalued at ₹ 30,200.

(c) Depreciate stock by 5% and Machinery by 10%.

Prepare Revaluation account, Partners Capital account and Balance Sheet of Anu and Beena.

8. Ashok, Babu and Chinu are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The firm's Balance Sheet on March 31, 2014 was as follows:

Liabilities		***Amount (₹)***	***Assets***		***Amount (₹)***
Sundry Creditors		38,000	Plant & Machinery		70,000
Bills Payable		10,000	Building		90000
General Reserve		24,000	Motor Car		16,000
Capitals:			Debtors	32,000	
Ashok	80,000		***Less:*** Provision		
Babu	60,000		for bad debts	1,000	31,000
Chinu	50,000	1,90,000	Stock		50,000
			Cash		5,000
		2,62,000			2,62,000

Babu retires on that date, subject to the following adjustments:

(a) The Goodwill of the firm to be valued at ₹ 36,000.

(b) Plants and Machinery to b depreciated by 10% and Motor Car by 15%.

(c) Stock to be appreciated by 20% and Building by 10%.

(d) Provision for Doubtful debts to be increased by ₹ 3,900.

Prepare Revaluation Account and Babu's Capital account.

9. Dhruv, Raja and Lela are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The Balance Sheet as on March 31, 2014 was as follows:

Liabilities		Amount (₹)	Assets		Amount (₹)
Sundry Creditors		31,200	Plant & Machinery		37,600
Dhruv Loan		10,000	Building		24,000
Capitals:			Debtors	24,800	
Dhruv	51,840		*Less :* Provision		
Raja	27,360		for bad debts	2,400	22,400
Lela	14 240	93,440	Stock		18,400
			Cash		32,240
		1,34,640			1,34,640

Dhruv retired on March 31, 2014 and Raja and Lela continued in partnership sharing profits and losses in the ratio of 2 : 1. Dhruv was paid ₹ 20000 on 1.4.2014 and it was agreed that the remaining balance due to him should be kept as his loan to the firm,

For the purpose of Dhruv's retirement it was agreed that

(a) Building be revalued at ₹ 48,000 and Plant and Machinery at ₹31,600.

(b) The provision for bad debts was to be increased by ₹800.

(c) A provision of ₹1,000 included in creditor was no longer required.

(d) ₹ 2,400 was to be written off from the stock in respect of damaged items included therein.

(e) A provision of ₹ 8,480 made in respect of outstanding legal charges.

(f) The goodwill of the firm to be valued at ₹ 28,800.

Prepare Revaluation Account, Capital A/c of partners and Balance sheet of the reconstituted firm.

10. Sunny, Honey and Rupesh are partners in a firm. Their Balance sheet as on December 31,2013 is as under:

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	20,000	Plant & Machinery	40,000
General Reserve	20,000	Furniture & Fittings	5,000

Capitals:			Debtors	30,000
Sunny	40,000		Stock	21,000
Honey	30,000		Investment	24,000
Rupesh	10,000	80,000		
		1,20,000		1,20,000

Honey died on 30.06.2014. The partnership deed provides that the representative of the deceased partner shall be entitled to:

(i) Balance of the capital account of deceased partner.

(ii) Interest on Capital at 8% p.a. upto date of death.

(iii) His share of profit upto date of death on the average of last three years profit.

(iv) His share of any undistributed profit and losses as per last balance sheet.

(v) Profit for the last three years was ₹ 30,000, ₹ 40,000 and ₹ 50,000.

Ascertain the amount payable to the legal representatives of Honey.

ANSWERS TO INTEXT QUESTIONS

24.1 I. (a) Old age (b) Poor health (c) Bad relations

II. Existing share + Gaining share

III. Existing share

IV. 2 : 1

24.2 (i) False, (ii) True, (iii) False, (iv) False.

24.3 I. (a) Gain/Profit, (b) Credit : Partners' Capital A/c, (c) Revaluation, Assets

II. Revaluation A/c Dr.
To Creditors A/c
(Increase in value of creditors)

24.4 I.
i. The balance of his/her Capital Account;
ii. His/her share in the Goodwill of the firm;
iii. His/her share in the Revaluation Profit:
iv. His/her share in General Reserve and Accumulated Profit;
v. Interest on Capital OR any other

Notes

II. 1. Lumpsum 2. Instalments

III. ₹ 32,000.

24.5 i. Mahinder's Capital ₹ 50,000, Tarun's Capital ₹ 30,000

ii. Amisha Capital ₹ 1,37,500, Neena Capital ₹ 82,500 Total Capital ₹2,20,000.

24.6 (i) Deceased partner, (ii) credited, (iii) Time, Sales, (iv) Executor's (v) debited

ANSWERS TO TERMINAL EXERCISE

5. New Ratio 1 : 1

6. Gaining Ratio 21 : 11

7. Loss on Revaluation ₹ 600
   Total of Balance Sheet ₹ 74,600

8. Profit on Revaluation ₹ 5,700,
   Balance of Babu Capital Account ₹ 81,900.

9. Profit on Revaluation ₹ 7,320
   Total of Balance Sheet ₹ 1,22,680.

10. Amount payable to Honney's Executor ₹ 44,534.

25

DISSOLUTION OF PARTNERSHIP FIRM

Rakesh and Mukesh were very good friends. They were running a business as a partnerhsip firm. They were very successful. People were jealous of their relations. But one day people came to know that they have closed the business. Some dispute had arisen between the two on a trivial issue. Similarly, firm may come to an end because of dispute among the partners or firm running in losses for last few years or because of order of the court and so on. We can say that the partnership firm is dissolved. In this lesson, you will learn about the accounting treatment in case of dissolution of partnership firm.

OBJECTIVES

After going through this lesson, you will be able to:

- state the meaning of dissolution of partnership firm;
- distinguish between dissolution of partnership and dissolution of partnership firm:
- explain the Realisation account and disposal of assets and payment of liabilities;
- illustrate the treatment of unrecorded assets and liabilities; and
- prepare partners' capital accounts and bank and/or cash account.

25.1 DISSOLUTION OF PARTNERSHIP AND DISSOLUTION OF PARTNERSHIP FIRM

The term dissolution means coming to an end or discontinuation. The dissolution of the firm implies a complete breakdown of the partnership relation among all the

partners. Dissolution of the partnership (owing to retirement, death or insolvency of a partner), merely involves change in the relation of the partners but it does not end the firm; the partnership would certainly come to an end but the firm, the reconstituted one might continue under the same name. So the dissoluton of the partnership may or may not include the dissolution of the firm but the dissoluton of the firm necessarily means the dissoluton of the partnership. On dissolution of the firm, the business of the firm ceases to exist since its affairs are wound up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

(i) Dissolution by Agreement : A firm is dissolved in case

- all the partners give consent or
- as per the terms partnership agreement .

(ii) Compulsory dissolution : A firm is dissolved compulsorily in the following cases

- When all the partners or all excepting one partner becomes insolvent or of unsound mind.
- When the business becomes unlawful.
- When all the partners excepting one decide to retire from the firm.
- When all the partners or all excepting one partner die.
- A firm is also dissolved compulsorily if the partnership deed includes any provision regarding the happening of the following events
  - (a) expiry of the period for which the firm was formed,
  - (b) completion of the specific venture or project for which the firm was formed.

(iii) Dissolution by Notice : In case of a partnership at will, the firm may be dissolved if any one of the partner gives a notice in writing to the other partners.

(iv) Dissolution by Court : A court may order a partnership firm to be dissolved in the following cases:

(a) When a partner becomes of unsound mind

(b) When a partner becomes permanently incapable of performing his/her duties as a partner,

(c) When partner deliberately and consistently commits breach of agreements relating to the management of the firm;

(d) When a partner's conduct is likely to adversely affect the business of the firm;

(e) When a partner transfers his/her interest in the firm to a third party;

(g) When the court regards dissolution to be just and equitable.

Distinction Between Dissolution of Partnership and Dissolution of Partnership Firm

Notes

You have already studied that on the occasion of admission, retirement and death existing partnership comes to an end, but the business of the firm continues under a new agreement. When a firm decides to wind up its business operations under any of the circumstances mentioned, it stands dissolved. Dissolution of a partnership firm is different from the dissolution of a partnership.

Dissolution of a firm means that the firm closes its business and comes to an end. While dissolution of a partnership means termination of old partnership agreement and a reconstitution of firm due to admission, retirement and death of a partner. In dissolution of a partnership the remaining partners may agree to carry on the business under a new agreement.

INTEXT QUESTIONS 25.1

Fill in the blanks with the appropriate word/words :

i. A partnership firm comes to an end when the activities of the firm become ....

ii. When a firm decides to close its business, it is said to be ....

iii. Dissolution of a .... is different from dissolution of ....

iv. The firm is compulsorily .... when all the partners or all excepting one partner die.

v. The firm is dissolved by .... when a partner becomes of unsound mind.

vi. The firm is dissolved by .... when all the partners give their consent.

25.2 TREATEMENT OF ASSETS AND LIABILITIES

When the partners decide to discontinue the business of the firm, it becomes necessary to settle its accounts. For this purpose, it disposes off all its assets (except cash and bank balances) for satisfying all the claims against it. For this purpose a separate account called 'Realisation Account' is opened. Realisation Account is an account in which assets excluding cash in hand and bank are transferred at their book value and all external liabilities are transferred at their book value.

Notes

It also shows what amount were realised on the sale of assets and which liabilities were discharged at what amount.

In order to record the disposal of assets and discharge of liabilities, the following journal entries are recorded:

1. **For Transfer of Assets :** Assets account is closed by transferring it to the Realisation Account at its Book Value.

   Realisation A/c   Dr.
       To Assets A/c (Individually)
   (Transfer of assets)

   It is to be noted that the following items on the assets side of the Balance Sheet are not transferred to the Realisation Account :

   (a) (i) Undistributed loss (i.e. Debit Balance of Profits and Loss account)
   (ii) Fictitious assets or deferred revenue expenditures such as preliminary expenses .

   All the above items are closed by transferring them to the partners' Capital Account in their profit sharing ratio. The Journal entry is made:

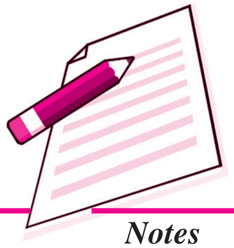
   Partner's capital A/c   Dr. (Individually)
       To Profit & Loss A/c
       To Fictitious Assets A/c
   (Transfer of loss and fictitious Assets)

   (b) Cash in hand, and Cash at Bank, will be the opening balance of the Cash/ Bank account;

   (c) Provisions and reserves against assets should be closed by crediting the Realisation Account.

   The Journal entry is made :

   Provision for Doubtful Debts A/c   Dr.
   Provision for Depreciation A/c   Dr.
   Any other Provision A/c   Dr.
       To Realisation A/c
   (Transfer of provision on assets)



2. **For Transfer of Liabilities :** The accounts of various external liabilities are closed by transferring them to the Realisation Account. The loan given to the firm by a partner's wife is treated as an external liability and is transferred to the credit of Realisation Account. The relevant Journal entry is as under :

External Liabilities A/c Dr. (Individually)
To Realisation A/c
(Transfer of external liability)

Capital and Loan account of the partners' are treated separately and so are not transferred to the Realisation Account.

3. **Treatment of Accumulated Reserves and Profit/Loss :** Any balance of accumulated reserves (e.g. general reserves), Profit and Loss Account (Cr.), Reserve Fund and other reserves on the date of dissolution will be credited to the Partners' Capital accounts on the basis of profit sharing ratio. The following journal entry will be recorded :

Profit and Loss A/c Dr.
General Reserve A/c Dr.
Any Other Fund Dr.
To Partners' Capital A/c (Individually)
(Transfer of profit and reserve)

4. **For Sale of Assets (for cash)**

Bank/ Cash A/c Dr. (Realised Value)
To Realisation A/c
(Sale of assets)

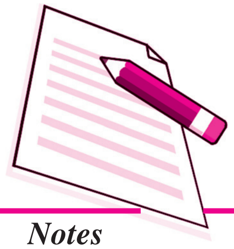
5. **For Assets taken Over by the Partner**

Partners' Capital A/c Dr.
To Realisation A/c (Agreed Price)
(Assets taken over by partner)

Bank/Cash/Partners capital A/c Dr.
To Partner's Loan A/c
(Settlement of loan to a partner)

6. **Settlement of loans given by the Partner**

Partners' Loan A/c Dr.
To Bank/Cash/Partners' capital A/c
(Settlement of loan given by the partner)



Notes

7. Payment of Liabilities in Cash

Realisation A/c Dr.
To Cash A/c
(Payment of liabilities)

8. Payment of Liabilities by the Partner(s)

Realisation A/c Dr.
To Partner Capital A/c
(Liabilities taken over by partner)

Treatment of Unrecorded Assets and Liabilities

Sometimes, there may be some assets that have already been written off completely in previous years and thus, do not appear in the Balance Sheet but physically they still exist for operational purposes. For example, there is an old computer, which is still in working condition though its book value is zero. Similarly, there may be some liabilities, which do not appear in the Balance Sheet, but actually they are still there. For example, a bill discounted with bank, on dissolution it was dishonoured and had to be taken up by the firm for payment purposes.

It is to be kept in mind that an unrecorded asset would never be transferred to the debit of the Realisation Account, because the amount realised from its sale is in nature of a gain and the Realization Account is only credited accordingly. Similarly, an unrecorded liability need not be transferred to Realisation.

Reason being that its payment is a loss and Realisation Account is only debited with the actual payment. In such cases, the following journal entries are made:

(a) When the amount realised from the sale of an unrecorded asset.

Cash/Bank A/c Dr.
To Realisation A/c
(Sale of unrecorded assets)

(b) When an unrecorded asset is taken over by a partner at an agreed value.

Partner's Capital A/c Dr.
To Realisation A/c
(Unrecorded assets taken by partner)

(c) When unrecorded liability has been discharged by the firm.

Realisation A/c Dr.
To Bank/Cash A/c
(Payment of unrecorded liabilities)

(d) When an unrecorded liability is discharged by a partner on behalf of the firm.

Realisation A/c	Dr.	
To Partner's Capital A/c		
(Unrecorded Liabilities payment by partner)		

Payment of Realisation Expenses

(a) When realisation expenses are paid by the firm (i.e. borne by the firm). The following journal entry will be recorded:

Realisation A/c	Dr.	
To Bank/ Cash A/c		
(Payment of realisation expenses)		

(b) When Realisation expenses are paid by the partner on behalf of the firm (i.e. realisation expenses paid by the partner but borne by the firm). The following journal entry is made:

Realisation A/c	Dr.	
To Partners' Capital A/c		
(Payment of realisation expenses by partner on behalf of firm)		

(c) Realisation expenses were agreed to be paid by the partner and were paid by the firm

Partner's Capital A/c	Dr.	
To Cash/Bank A/c		
(Realisation expenses paid and borne by partner)		

Closing of Realisation Account

The balance in the realisation account would show either profit or loss on dissolution. If the total of the credit side is more than the debit side, then there is a profit and following journal entry is made :

Realisation A/c	Dr.	(Individually)
To Partner's Capital/ Current A/c		(Individually)
(Profit on realisation transferred to capital accounts)		

If, the debit side is more than credit side, then there is a loss on dissolution and following journal entry is made :

Partner's Capital/Current A/c	Dr.	(Individually)
To Realisation A/c		
(Loss on realisation transferred to capital account)		

Notes

Format of Realisation Account

Realisation Account

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
All Assets A/c (Book Value) (Except Cash/Bank)		**All External Liabilities A/c (Book Value)**	
Cash/Bank A/c (Payment of external liabilities)		**Cash/Bank A/c** (Amount realised on sale of various assets)	
Partners Capital A/c (if any liability paid by partner)		**Partners' capital A/c** (If any asset is taken over)	
Cash/Bank A/c (Expenses on realisation)		**Partners Capital A/c** (For transferring loss on realisation)	
Partners Capital A/c (Expenses on realisation paid by a partner)			
Partners Capital A/c (For transferring profit on realisation)			

INTEXT QUESTIONS 25.2

Given below are certain statements. Some of these statement are true and some of these are false. Write T' against true statement and 'F' against false statements.

(i) At the time of dissolution an account including cash and bank are transferred to realisation account.

(ii) On dissolution of a firm, business operations of the firm are closed down.

(iii) After the preparation of realisation account, Gain or loss of realisation is transferred to Partners capital account

(iv) Amount realised from the sale of an unrecorded asset is recorded in Realisation Account.

(v) Balance of general reserve is transferred to partners' capital accounts.

(vi) Realisation expenses paid by the partners on behalf of the firm are recorded in realisation account and partners capital account.

25.3 PARTNERS' CAPITAL ACCOUNT AND CASH/BANK ACCOUNT

Settlement of Partners' Capital Accounts

After all the adjustments related to partners' capital accounts and transfer of profit or loss on realisation to the partners' capital accounts, the capital accounts are closed in the following manner:

(a) If the Partner's Capital Account shows a debit balance, the partner has to bring the necessary amount of cash. The following journal entry is made :

Bank/Cash A/c Dr.
 To Partner's Capital A/c
(Cash brought by the partner)

(b) If the Partner's Capital Account shows a credit balance, he/she is to be paid off the necessary amount of cash. The following journal entry will be made:

Partner's Capital A/c Dr.
 To Bank/Cash A/c
(Cash paid to partner)

Preparation of Cash/Bank account

After closing the partners' capital accounts, bank account is prepared and all entries pertaining to the bank/cash are posted in it including any cash brought in by the partner on the dissolution of firm. Partners' capital accounts are closed by making payment from the bank account and thereby bank account stands closed by making/receiving payment. In this way all the accounts stand closed. If cash/bank account does not show any balance, it implies that all the accounts of the dissolved firm have been closed properly.

Illustration 1

Arun and Seema are equal partners in a firm. They decided to dissolve the partnership on December 31, 2014 when the balance sheet stood as under:

Notes

Balance Sheet as on December 31, 2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Sundry creditors		54,000	Cash at Bank	22,000
Reserve fund		20,000	Sundry Debtors	24,000
Loan		80,000	Stock	84,000
Capital :			Furniture	50,000
Arun	1,20,000		Plant	94,000
Seema	1,20,000	2,40,000	Leasehold land	1,20,000
		3,94,000		**3,94,000**

Assets were realised as follows:

	₹
Leasehold land	1,44,000
Furniture	45,000
Stock	81,000
Plant	96,000
Sundry debtors	21,000

The creditors were paid ₹ 51,000 in full settlement. Expenses of realisation amounted to ₹ 6,000.

Prepare Realisation account, Bank account, partners' capital accounts to close the books of the firm.

Solution :

Books of Arun and Seema

Realisation Account

Dr Cr.

Particulars		*Amount* (₹)	*Particulars*		*Amount* (₹)
Assets transferred			Sundry Creditors		54,000
Sundry Debtors	24,000		Loan		80,000
Plants	94,000		**Bank**		
Stock	84,000		Sundry Debtors	21,000	

Leasehold land	1,20,000		Plant	96,000	
Furniture	50,000	372000	Stock	81,000	
Bank			Lease hold land	1,44,000	
Creditors	51,000		Furniture	45,000	3,87,000
Loan	80,000				
Realisation Expense	6,000	1,37,000			
Profit transferred to					
Arun Capital	6,000				
Seema Capital	6,000	12,000			
		5,21,000			5,21,000

Notes

Capital Accounts

Dr. Cr.

Particulars	*Arun* (₹)	*Seema* (₹)	*Particulars*	*Arun* (₹)	*Seema* (₹)
Bank	1,36,000	1,36,000	Balance b/d	1,20,000	1,20,000
			Reserve fund	10,000	10,000
			Realisation (Profit)	6,000	6000
	1,36,000	1,36,000		1,36,000	1,36,000

Bank Account

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Balance b/d	22,000	Realisation A/c	1,37,000
Realisation A/c	3,87,000	Arun Capital	1,36,000
		Seema Capital	1,36,000
	4,09,000		4,09,000

Illustration 2

Sonya and Mayank are partners, who shared profit as 3:2. Following is the balance sheet as on December 31, 2014

Balance Sheet as on December 31, 2014

Liabilities	*Amount (₹)*	*Assets*		*Amount (₹)*
Creditors	28,000	Cash in hand		10,500
Bills payable	20,000	Cash at Bank		30,000
Profit & Loss A/c	13,500	Stock		7,500
Sonya's Capital	32,500	Sundry debtors	21,500	
Mayank's Capital	11,500	*Less :* Provision		
		for bad debt	500	21,000
		Land & Building		36,500
	1,05,500			1,05,500

The firm was dissolved on December 31, 2014. Close the books of the firm with the following information:

(i) Debtors realised at a discount of 5%.

(ii) Stock realised at ₹ 7,000.

(iii) Building realised at ₹ 42,000.

(iv) Realisation expenses amounted to ₹ 1,500 .

(v) Creditors and bills payable are paid in full.

Prepare necessary ledger accounts.

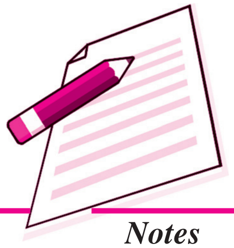
Solution :

Books of Sonya and Mayank

Realisation Account

Dr. Cr.

Particulars		*Amount (₹)*	*Particulars*		*Amount (₹)*
Assets transferred			Provision for bad debts		500
Stock	7,500		Creditors		28,000
Sundry assets	21,500		Bills payable		20,000
Land & Building	36,500	65500	**Bank**		
Bank			Debtors	20,425	
Creditors	28,000		Stock	7,000	



Bills payable	20,000		Land & Building	42,000	69,425
Realisation [Expense]	1,500	49500			
Profit transferred to (3 : 2)					
Sonya's Capital	1,755				
Mayank's Capital	1,170	2,925			
		1,17,925			1,17,925

Capital Accounts

Dr. Cr.

Particulars	*Sonya* (₹)	*Mayank* (₹)	*Particulars*	*Sonya* (₹)	*Mayank* (₹)
Bank	42,355	18,070	Balance b/d	32,500	11,500
			Profit & Loss A/c	8,100	5,400
			Realisation (Profit)	1,755	1,170
	42,355	18,070		42,355	18,070

Bank Account

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Balance b/d	30,000	Realisation	49,500
Cash	10,500	Sonya's Capital	42,355
Realisation	69,425	Mayank's Capital	18,070
	1,09,925		1,09,925

Illustration 3

Tanu, Manu and Chetan are in partnership sharing profit in the proportion of 1/2, 1/3, 1/6 respectively. They dissolve the partnership firm on the December 31, 2014, when the balance sheet of the firm stood as under:

Balance Sheet as on December 31, 2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Sundry Creditors		30,000	Bank	37,500
Bills payable		25,000	Sundry debtors	58,000
Manu's loan		40,000	Stock	39,500
Capital			Investment	42,000
Tanu	90,000		Machinery	48,000
Manu	75,000		Freehold property	90,000
Chetan	55,000	2,20,000		
		3,15,000		3,15,000

The machinery was taken over by Manu for ₹ 45,000, Tanu took over the investment for ₹ 40,000 and freehold property was taken over by Chetan at ₹95,000. The remaining assets realised as follows: Sundry Debtors ₹ 56,500 and Stock ₹ 36,500. Sundry creditors were settled at discount of 5%. Bills payable is taken over by Chetan for ₹ 23,000. Their liabilities amounting to ₹3,000 not shown in books are also to be paid. An office computer, not shown in the books of accounts, realised ₹ 9,000

Realisation expenses amounted to ₹ 3,000.

Prepare Realisation Account, Partners Capital account and Bank Account.

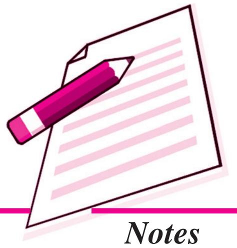
Solution:

Books of Tanu Manu and Chetan

Realisation Account

Dr. Cr.

Particulars		*Amount* (₹)	*Particulars*	*Amount* (₹)
Assets transferred			Sundry Creditors	30,000
Sundry debtors	58,000		Bills payable	25,000
Stock	39,500		Tanu Capital (Investment)	40,000
Machinery	48,000		Manu Capital (Machinery)	45,000
Investment	42,000		Chetan Capital	95,000
Freehold property	90,000	277500	(freehold property)	



Notes

Chetan Capital		23,000	**Bank**		
(Bills payable)			S.Debtors	56,500	
Bank			Stock	36,500	
S.Creditors	28,500		Computer	9,000	1,12,000
Liabilities	3,000				
(Unrecorded)					
Realisation	6,000	37,500			
[Expense]					
Profit transferred to					
Tanu Capital	4,500				
Manu Capital	3,000				
Chetan Capital	1,500	9,000			
		3,47,000			3,47,000

Capital Account

Dr. Cr.

Particulars	*Tanu* (₹)	*Manu* (₹)	*Chetan* (₹)	*Particulars*	*Tanu* (₹)	*Manu* (₹)	*Chetan* (₹)
Realisation	40,000	45,000	95,000	Balance b/d	90,000	75,000	55,000
(Assets)				Realisation	—	—	23,000
Bank	54,500	33,000	—	(Assets)			
				Realisation	4,500	3,000	1,500
				(Profit)			
				Bank	—	—	15,500
	94,500	78,000	95,000		94,500	78,000	79,500

Bank Account

Dr. Cr.

Particulars	*Amount* (₹)	*Particulars*	*Amount* (₹)
Balance b/d	37,500	Realisation	37,500
Realisation	1,12,000	Manu's loan	40,000
Chetan Capital	15,500	Tanu Capital	54,500
		Manu Capital	33,000
	1,65,000		1,65,000

Notes

INTEXT QUESTIONS 25.3

I. Which of the following is treated as unrecorded asset :

i. Sale of old Furniture.

ii. Goodwill appearing in the balance sheet.

iii. Bad debts recovered, written off in pervious year.

iv. Sale of Investments.

v. Sale of old computer, written off in pervious year.

II. Which of the following is treated as unrecorded liability :

i. A Bill Discounted with bank dishonoured.

ii. Repayment of Bank Loan.

iii. Creditors for stock purchase of goods.

iv. Settlement of a dispute against the firm.

v. Payment of outstanding bills.

WHAT YOU HAVE LEARNT

- When a firm decides to close its business and no business activity is carried out by the firm, it is said to be dissolved.
- Dissolution of a firm is different from the dissolution of a partnership. Dissolution of a firm means that the firm closes its business and comes to an end. While dissolution of a partnership means termination of old partnership agreement and a reconstitution of firm due to admission, retirement and death of a partner.
- On dissolution of the firm the books of accounts are closed. All assets and liabilities are transferred to an account called "Realisation Account". This account records the realisation of assets and the payment of liabilities.
- When the partners decide to discontinue the business of the firm, it becomes necessary for it to settle its accounts. For this purpose, it disposes off all its assets (except cash and bank balances) for satisfying all the claims against it.
- An unrecorded asset would never be transferred to Realisation Account, because the amount realised from its sale is in the form of a gain and the Realization Account is only credited accordingly.
- After all the adjustments related to partners' capital accounts and transfer of profit or loss on realisation to the partners capital accounts, the capital accounts are closed.

- Partners capital accounts are closed through making payment from the bank account and thereby bank account stands closed by making/ receiving payment.

TERMINAL EXERCISE

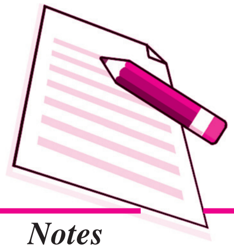
1. Answer the following questions in one sentence:
   (a) What is meant by dissolution of partnership firm ?
   (b) Why Realisation account is prepared ?
   (c) What journal entry is made in case of payment of unrecorded Liability?
   (d) What journal entry is made when expenses are agreed to be borne by the partners and paid by the firm.
2. Distinguish between dissolution of partnership firm and dissolution of partnership.
3. Under what circumstances can the court dissolve the partnership firm?
5. Sumit and Anish are equal partners in a firm. They decided to dissolve the partnership on December 31,2014 when the balance sheet is as under:

Balance Sheet as on December 31, 2014

Liabilities		*Amount (₹)*	*Assets*	*Amount (₹)*
Sundry creditors		30,000	Cash at Bank	7,000
Reserve fund		7,000	Sundry Debtors	23,000
Bills Payable		30,000	Stock	42,000
Capital			Furniture	35,000
Sumit	70,000		Plant	40,000
Anish	60,000	1,30,000	Leasehold land	50,000
		1,97,000		1,97,000

Assets were realised as :

	₹
Leasehold land	62,000
Furniture	30,500
Stock	40,500
Plant	48,000
Sundry debtors	22,500



Notes

Sundry creditors were paid ₹ 29,500 in full settlement. Bills payable paid 5% less. Expenses of realisation amounted to ₹ 2,500.

Prepare realisation account, Bank account and partners' capital accounts to close the books of the firm.

6. Ashu and Hemani are Partners sharing profit and losses in the ratio of 3 : 2. They decided to dissolve the firm on December 31 , 2014. Their balance sheet on the above date was :

Balance Sheet as on December 31, 2014

Liabilities		*Amount (₹)*	*Assets*	*Amount (₹)*
Capital			Building	90,000
Ashu	1,00,000		Machinery	60,000
Hemani	92,000	1,92,000	Furniture	10,000
Creditors		88,000	Stock	24,000
Bank overdraft		20,000	Investments	50,000
			Debtors	48,000
			Cash in hand	18,000
		3,00,000		3,00,000

Ashu is to take over the building at ₹ 98,000 and machinery and furniture is to be taken over by Hemani at value of ₹ 70,000. Ashu agreed to pay creditor and Hemani agreed to meet bank overdraft. Stock and investments are taken by both partners in their profit sharing ratio.

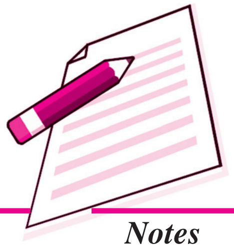
Debtors realised for ₹ 46,000, expenses of realisation amounted to ₹ 3,000.

Prepare necessary ledger accounts.

7. Tarun, Neeru and Vikas shared profit in the ratio of 3:2:1. On December 31, 2014 their balance sheet was as follows:

Balance Sheet as on December 31, 2014

Liabilities		*Amount (₹)*	*Assets*	*Amount (₹)*
Capital			Plant	80,000
Tarun	90,000		Debtors	70,000
Neeru	1,00,000		Furniture	22,000
Vikas	80,000	2,70,000	Stock	70,000
Creditors		60,000	Investments	60,000



Notes

Bills payable	30,000	Bills receivable	46,000
Reserve	20,000	Cash in hand	32,000
	3,80,000		3,80,000

On this date the firm was dissolved. The assets realised as follows: Plant ₹85,000, Debtors ₹69,000 Furniture ₹20,000, stock 95% of the book value, Investments ₹ 86,000 and Bills receivable ₹ 31,000. An office Electronic Typewriter, not shown in the books of accounts realised ₹ 9,000. Expenses of realisation amounted to ₹ 4,500. Creditor are taken over by Vikas at book value.

Prepare realisation account, Capital accounts and cash account

8. The following was the balance sheet of Anu and Hema as on December 31,2014:

Balance Sheet as on December 31, 2014

Liabilities		***Amount (₹)***	***Assets***	***Amount (₹)***
Sundry Creditors		42,000	Cash at Bank	13,000
Bills payable		26,000	Sundry debtors	50,000
Hema's loan		20,000	Stock	40,000
Reserve fund		6,000	Bills receivable	28,000
Provision of Bad debts		2,000	Machinery	60,000
Capital			Investment	30,000
Anu	90,000	1,52,000	Fixtures	27,000
Hema	62,000			
		2,48,000		2,48,000

The firm was dissolved on December 31, 2014 and assets realised and settlements of liabilities was as follows :

(a) The realisation of the assets were as follows:

	₹
Sundry debtors	48,000
Stock	38,000
Bills receivable	27,000
Machinery	62,000

(b) Investment was taken over by Hema at agreed value of ₹ 36,000 and agreed to pay of creditors. Bills payable is paid 3% less.

(c) Fixture are value less.

(d) The expenses incurred on realisation were ₹ 2,200.

Journalise the entries to be made on the dissolution and prepare realisation account, bank account and partners capital accounts.

Notes

9. Rohit and Tina were partners in a firm and shared profit as 3 : 2. They decided to dissolve their firm on March 31, 2014 when their balance sheet was as follows:

Balance Sheet as on March 31, 2014

Liabilities		*Amount* (₹)	*Assets*	*Amount* (₹)
Capital			Machinery	80,000
Rohit	80,000		Investments	60,000
Tina	90,000	1,70,000	Stock	22,000
Sundry creditors		70,000	Sundry Debtors	80,000
Reserve		10,000	Cash at bank	8,000
		2,50,000		2,50,000

The assets and liabilities were disposed off as follows:

(a) Machinery were given to creditors in full settlement of their account and stock is taken over by Rohit at ₹ 19,000.

(b) Investment were taken over by Tina at book value. Sundry debtors of book value ₹ 50,000 taken over by Rohit at 10% less and remaining debtors realised for ₹ 28,000.

(c) Realisation expenses amounted to ₹ 2,000 paid by Rohit.

Prepare necessary ledger accounts to close the books of the firm.

ANSWERS TO INTEXT QUESTIONS

25.1 (i) Unlawful (ii) Dissolved (iii) Firm, partnership
(iv) Dissolved (v) Court (vi) Agreement

25.2 (i) F (ii) T (iii) T (iv) T (v) T (vi) T

25.3 I. (c) and (e) II. (i) and (iv)

ANSWERS TO TERMINAL EXERCISE

5. Profit on Realisation ₹ 13,000 Total of Cash A/c ₹ 210500
6. Profit on Realisation ₹ 2000 Total of Cash A/c ₹ 64000
7. Profit on Realisation ₹ 14000 Total of Cash A/c ₹ 398500
8. Loss on Realisation ₹ 23420 Total of Cash A/c ₹ 188000
9. Loss on Realisation ₹ 92000 Total of Cash A/c ₹ 83800

26

COMPANY : AN INTRODUCTION

You may have come across the name of organisation with suffix limited (Ltd.), for example Hindustan Motors Ltd. or Hindustan Aeronautics Ltd. etc. Have you ever thought what does this indicate? Names of organisations with Ltd. indicate that these are forms of oganisations which are different from sole proprietorship or partnership. These are called joint stock companies.

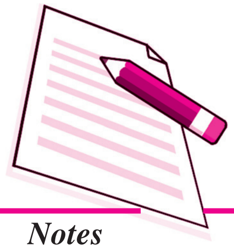
As you know that the sole proprietorship and partnership forms of business organisations could not meet the growing needs of huge capital and managerial skills required for increased scale of business and growing economic activities. The liability of owner/owners of these organisations is unlimited. In order to overcome these problems a new form of business organisation known as 'company' came into existence.

In this lesson, we shall study about company, its features and the methods of raising capital through issue of shares.

OBJECTIVES

After studying this lesson you will be able to :

- state the meaning of company as a form of business organisation;
- describe the characteristics of company;
- describe various types of companies;
- distinguish between public and private company;


Notes

- explain various types of shares;
- distinguish between equity shares and preference shares; and
- explain the types of share capital.

26.1 COMPANY–MEANING AND CHARACTERISTICS

A company is a voluntary association of individuals formed to carry on business to earn profits or for non profit purposes. These persons contribute towards the capital by buying its shares in which it is divided. A company is an association of individuals incorporated as a company possessing a common capital i.e. share capital contributed by the members comprising it for the purpose of employing it in some business to earn profit.

> As per Companies Act 1956, a company is formed and registered under the Companies Act or an existing company registered under any other Act".

Characteristics of a Company

Following are the main characteristics of a company:

- **Artificial Legal Person :** A company is an artficial person as it is created by law. It has almost all the rights and powers of a natural person. It can enter into contract. It can sue in its own name and can be sued.
- **Incorporated Body :** A company must be registered under Companies Act. By virtue of this, it is vested with corporate personality. It has an identity of its own. Although the capital is contributed by its members called shareholders yet the property purchased out of the capital belongs to the company and not to its shareholders.
- **Capital Divisible into Shares :** The capital of the company is divided into shares. A share is an indivisible unit of capital. The face value of a share is generally of a small denomination which may be of ₹ 1, ₹ 2, ₹ 5, ₹ 10, ₹ 25 or ₹ 100 etc.
- **Transferability of Shares :** The shares of the company are easily transferable. The shares can be bought and sold in the stock market.
- **Perpetual Existence :** A company has an independent and separate existence distinct from its shareholders. Changes in its membership due to death, insolvency etc. does not affect its existence and its continuity.

- **Limited Liability :** The liablity of the shareholders of a company is limited to the extent of face value of shares held by them. No shareholder can be called upon to pay more than the face value of the shares held by them. At the time of winding up, if necessary, the shareholders may be asked to pay the unpaid value of shares.

- **Representative Management :** The number of shareholders is so large and scattered that they cannot manage the affairs of the company collectively. Therefore they elect some persons among themselves to manage and administer the company. These elected representatives of shareholders are individually called the 'directors' of the company and collectively the Board of Directors.

- **Common Seal :** A common seal is the official signature of the company. Any document bearing the common seal of the company is legally binding on the company.

Nature of Company

In the beginning, the size of business firms were very small. Sole proprietorship was therefore, the usual form of business organisation. Later on partnership become popular when the size of business firms increased. But sole proprietorship and partnership could not meet the growing demand of big size business because of their limitations such as limited capital, limited managerial ability, unlimited liability and other drawbacks. Therefore, in the present days of business world, it is only the Joint stock company form of business organisation which proved to be useful.

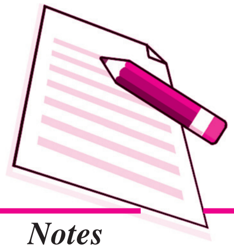
A company is a voluntary association of persons formed for some common purpose, with capital divisible into parts, known as shares and with a limited liability. It is created by law and is known as an artificial person with a perpetual succession and a common seal. It has a separate legal entity.

INTEXT QUESTIONS 26.1

I. Fill in the blanks with correct word/words relating to the characteristics of the company:

(i) A company is created by law. Hence a company is ....

(ii) An indivisible unit of capital of a company is called a ....



Notes

(iii) .... is the official signature of the company.

(iv) The shareholders elect some persons of their choice to manage the company's affairs. It explains the .... character of the company.

II. Identify the correct statement by marking (√) and incorrect one by marking (×):

(i) The property of a company belongs to its shareholders.

(ii) The liability of every member of company is restricted to the face value of shares held by them.

(iii) The members of a company cannot transfer their shares freely.

(iv) A company can enter into contract in its own name.

26.2 TYPES OF COMPANIES

Companies can be classified under the following heads:

1. On the basis of formation.
2. On the basis of liability.
3. On the basis of ownership.

1. On the basis of Formation

On the basis of formation companies can be categorised as :

(a) Statutory Company : A company formed by a Special Act of parliament or state legislature is called a Statutory Company. Reserve Bank of India, Industrial Financial Corporation of India, Life Insurance Corporation of India, Delhi State Finance Corporation are some of its examples.

(b) Registered Company : A company formed and registered under the Companies Act, 1956 or earlier Companies Acts is called a Registered Company. The working of such companies is regulated by the provisions of the Companies Act.

2. On the basis of Liability

On the basis of liabilty, companies can be categorised as:

(a) Company Limited by Shares : The liability of the member of such company is limited to the face value of shares held by him/her.

(b) Company Limited by Guarantee : The liabilty of each member of such company is limited to the extent of guarantee undertaken by the member. It may arise in the event of it being wound up.

Notes

(c) **Unlimited Company :** The company not having any limit on the liability of its members, is called an unlimited company. Liability in such a case extends to the personal property of its shareholders. Such companies do not use the word 'limited' at the end of their name.

(d) **Company Under Section 25 :** A company created under section-25 is to promote art, culture and societal aims. Such companies need not use the term limited at the end of their name. Punjab, Haryana, Delhi chambers of commerce, etc. are the examples of such companies.

3. On the basis of Ownership

On the basis of ownership, companies can be catagorised as :

(a) **Private Company :** A private company is one which by its Articles of Association :

(i) restricts the right of members to transfer its shares;

(ii) limits the number of its members to fifty (excluding its past and present employees);

(iii) prohibits any invitation to the public to subscribe to its shares, debentures.

(iv) The minimum paid up capital of the company is one lakh rupees (₹ 100000).

The minimum number of shareholders in such a company is two and the company has to add the words 'private limited' at the end of its name. Private companies do not involve participation of public in general.

(b) **Public Copmpany :** A company which is not a private company is a public company. Its Articles of association does not contain the above mentioned restrictions.

Main features of a public company are :

(i) The minimum number of members is seven.

(ii) There is no restriction on the maximum number of members.

(iii) It can invite public for subscription to its shares.

(iv) Its shares are freely tansferable.

(v) It has to add the word 'Limited' at the end of its name.

(vi) Its minimum paid up capital is five lakhs rupees (₹ 500,000).

(c) **Government Company :** A Government company is one in which not less than 51% of its paid up capital is held by (1) Central Government or (2) State Government, or (3) partly by Central Government and partly by State Government. Example of a Government company is Hindustan Machine Tools Limited, (HMT) State Trading Corporation (STC). Minerals and metals trading corporation (MMTC).

(d) **Foreign Company :** A foreign company is one which is incorporated outside India but has a place of business in India, for example Philips, L.G, etc.

(e) **Holding Company and Subsidiary Company :** A holding company is a company which controls another company (called subsidiary company) either by acquiring more than half of the equity shares of another company or by controlling the composition of Baord of Directors of another company or by controlling a holding company which controls another company.

(f) **Listed Company and Unlisted Company :** A company is required to file an application with stock exchange for listing of its securities on a stock exchange. When it qualifies for the admission and continuance of the said securities upon the list of the stock exchange, it is known as listed company. A company whose securities do not appear on the list of the stock exchange is called unlisted company.

Difference between public company and private company :

The major differences between public company and private company are as follows:

Difference between Public Company and Private Company

Basis of Difference	*Public Comapany*	*Private Company*
1. Minimum Number of Members	Minimum mumber of members required to form a public company is **seven.**	Minimun number of members required to form a private company is **two.**
2. Maximum number of Members	No limit on miximum number of members.	Maximum number of members is **fifty.**
3. Name	The word 'Limited' is used at the end of the company's name.	The word 'Private Limited' is used at the end of the company's name.

4. Commencement of Business	It can start its business only after getting a certificate of commencement of business.	It can commence its business as soon as it obtains certificate of Incorporation.
5. Invitation to Public	It invites public to subscribe to its shares.	It cannot invite public to subscribe to its shares.
6. Transfer of Shares	There is no restriction on transfer of its shares.	There is restriction on the transfer of its shares.
7. Number of Directors	It must have at least **three** directors.	It must have at least **two** directors.
8. Minimum Capital	It must have a minimum paid up capital of five lakh rupees (₹ 500000)	It must have a minimum paid up capital of one lakh rupees (₹ 100000).

INTEXT QUESTIONS 26.2

I. Fill in the blanks with correct words/figures given in brackets :

(i) The minimum number of members in a public limited company is …………(two, five, seven)

(ii) A Government company is one in which not less than ……..…of its paid up capital is held by government. (50%, 51%, 75%)

(iii) The minimum paid up capital of a private limited company is……. (rupees one lakh, rupees five lakh, rupees Ten lakh)

(iv) A foreign company is one which is incorporated …..……. (In India, Outside India).

II. Name the type of company in the following cases :

(i) A company that imposes restriction on transfer of its shares by its Articles of Association.

(ii) A company with a liability of its members limited to the extent of the amount unpaid on its shares.

(iii) A company formed by a Special Act enacted by parliament or state legislature.

(iv) A company not having any limit on the liability of its members.

(v) A company which controls another company.

26.3 SHARES-MEANING AND ITS KINDS

Notes

A joint stock company divides its capital into units of equal denomination. Each unit is called a share. These units i.e. shares are offered for sale to raise capital. This is termed as issuing shares. A person who buys share/shares of the company is called a shareholder and by acquiring share or shares in the company he/she becomes one of the members of the company.

Thus, a share is an indivisible unit of capital. It expresses the proprietory relationship between the company and the shareholder. The denominated value of a share is its face value. The total capital of a company is divided into number of shares.

Kinds of Shares

According to the Companies Act, a company can issue the following types of Shares:

(i) Preference Shares (ii) Equity Shares

(i) Preference Shares : A preference share is one which carries following preferential rights over other type of shares called equity shares in regard to the following :

- Payment of dividend
- Repayment of capital at the time of winding up of the company.

Characteristics of Preference Shares

i. Such type of shareholders have priority in the payment of dividend before any other class of shareholders get their payment of dividend.

ii. The rate of dividend of such shares are pre-determined.

(ii) Equity Shares : All shares which are not preference shares are equity shares. Holders of these shares receive dividend out of the profits of the company after the payment of dividend has been made to the preference shareholders.

Characteristics of Equity Shares

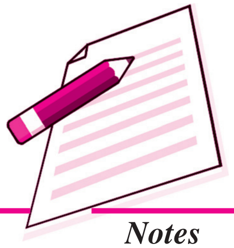
i. Its dividend rate can change from year to year.

ii. Dividend on Equity shares is paid after the payment of dividend to preference shareholders.

iii. In the event of winding up of company the repayment of capital to equity shareholder is made at last.

iv. They are real owners of the company.

Equity shareholders have the right to elect directors of the company. Equity shares are the permanent source of capital.



Notes

Difference between Equity Shares and Preference Shares

Basis of Difference	Equity Shares	Preference Shares
1. Rate of Dividend	Rate of dividend on these shares is not fixed and depends upon the decision of the Board of directors.	Rate of dividend on these shares is fixed.
2. Payment of Dividend	Dividend on these shares is paid after payment of dividend to preference shareholders.	Dividend on these shares is paid before payment of dividend to equity shareholders.
3. Refund of Share Capital on Winding up of the Company	On winding up of the company equity share holders get refund of capital only after preference share holders have been paid off.	Preference shareholders have a preference over equity shareholders in regard to refund of capital in case of winding up of the company.
4. Voting Rights	Shareholders have voting rights in all matters.	Shareholders can vote only in special circumstances.
5. Redemption	Shares cannot be redeemed during the life of the company.	Shares can be redeemed as per terms of issue.

Illustration 1

Alok Ltd. issued 12000 share of ₹ 10 each. The amount payable on shares was ₹ 2 on application, ₹ 4 on allotment and ₹ 4 on First & Final Call. All the shares were subscribed & all calls were received on due dates.

Pass the necessary Journal entries in the books of the company.

Solution :

Journal

Date	*Particulars*		*L.F.*	*₹ (Dr.)*	*₹ (Cr.)*
	Bank A/c	Dr.		24,000	
	To Share Application A/c				24,000
	(Being application money received)				
	Share Application A/c	Dr.		24,000	
	To Share Capital A/c				24,000
	(Being application money transferred to share capital A/c)				
	Share Allotment A/c	Dr.		48,000	
	To Share Capital A/c				48,000
	(Being allotment money due)				
	Bank A/c	Dr.		48,000	
	To Share Allotment A/c				48,000
	(Being allotment momey received)				
	Share First & Final Call A/c	Dr.		48,000	
	To Share Capital A/c				48,000
	(Being First & Final Call money due)				
	Bank A/c	Dr.		48,000	
	To Share First & Final Call A/c				48,000
	(Being First & Final Call money received)				

INTEXT QUESTIONS 26.3

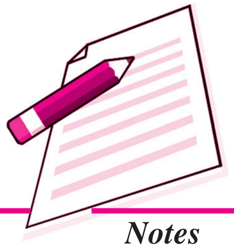
Fill in the blanks with suitable word/words.

i. In a company, main source of finance is ....

ii. A .... is an indivisible unit of capital

iii. .... have the right to elect directors of the company

iv. .... have the preferential right as the refund of capital in case of winding up of company over ....



Notes

26.4 SHARE CAPITAL–MEANING AND ITS TYPES

A joint stock company estimates its future capital requirements. The amount of the capital is mentioned in the capital clause of the Memorandum of Association registered with the Registrar of the Companies. Total capital is divided into a number of small indivisible units of fixed amount and each such unit is called a share. A share is nothing but a part in the share capital of the company. As the total capital of the company is divided into shares, the capital of the company is called share capital. Share capital of the company is divided into following categories:

- **Nominal/Authorised/Registered Capital :** It refers to the maximum amount of share capital which a company is authorised to issue as per its Memorandum of Association.
- **Issued Capital :** Issued capital is that part of the authorised capital which the company offers to public, that may include vendors, for subscription or purchase. A company may issue its entire authorised capital or may issue it in parts from time to time as per the needs of the company. It means and includes the nominal value of shares issued by the company for (a) cash, and (b) consideration other than cash to (i) promoters of a company, and (ii) others.
- **Subscribed Capital :** It is that part of issued capital which is taken up or subscribed by those who are offered for subscription. Company may receive application for equal to, more than or less than shares issued. This capital can be equal to or less than the issued capital. The portion of nominal value of the issued share capital which is actually paid (or subscribed) by the shareholders forms part of the subscribed capital.
- **Called up Capital :** It is that part of the issued/subscribed capital which is called up by company to pay on the allotted shares and is to be paid by the shareholders. The portion of the issue price of the shares which a company has demanded or called from shareholders is known as called up capital
- **Uncalled Capital :** Uncalled Capital is that portion of the issued/subscribed capital that is not called up by the company on the shares allotted.
- **Paid up Capital :** It is the portion of called up capital which has been paid by the shareholders, to calculate the paid up capital, the amount of instalments in arrears is deducted from the called up capital.

- **Unpaid Capital :** That part of the called up capital which has been called but has not been paid by the shareholders is called unpaid capital. *i.e.* calls-in-arrears.

- **Reserve Capital :** Company may keep some part of its share capital uncalled and keep in reserve to be called only in case of need at the time of its winding up. This is known as Reserve capital. For this, a special resolution will have to be passed by the company. Thus, it is that portion of the uncalled capital which a company has decided to call only in case of liquidation of the company.

INTEXT QUESTIONS 26.4

I. Fill in the blanks with suitable word/words :

(i) Share capital is the amount of capital raised through …………..

(ii) Capital stated in the capital clause of the Memorandum of Association is called …………..

(iii) That part of the authourised capital which is offered to public for subscription is called …………..

(iv) That part of the uncalled capital which is kept in reserve to be called only on winding up of the company is termed as ………..

II. Write 'correct' for correct statement and 'wrong' for incorrect statement for the following :

(i) Subscribed capital is either equal to or less than issued capital

(ii) Issued capital is stated in the capital clause of Memorandum of Association

(iii) Liability of a shareholder is limited upto the face value of the share

(iv) Reserve capital can be called by the company at any time.

26.5 PRIVATE PLACEMENT OF SHARES

According to **Section 81 (1A)** of Companies Act, 1956 private placement of shares implies issue and allotment of shares to a selected group of persons.

A private company limited by shares is prohibited by the Companies Act from issue of shares for public subscription. It also need not file a statement in lieu of prospectus. Its shares are issued privately to a small number of persons known as promoters or

related to them by family connections. This is an easy way of raising capital which involves less legal formalities. **However, a public company can also raise the capital by placing the shares privately and without inviting the public for subscription.** Such Private Placement requires special resolution to be passed by the company or consent of Central Government. An underwriter or broker finds clients who wish to buy shares. Since, no public offer is made, there is no need to issue prospectus. Statement in lieu of prospectus should be filed with registrar of companies in such a case.

Accounting treatment of private placement is similar to the public subscription.

Salient Features of Private Placement are as follows :

i. The company needs to prepare a draft prospectus known as "Statement in lieu of Prospectus" and must file with the registrar atleast 3 days before the allotment of shares or debentures.

ii. Private Placement of shares and debentures is carried only in the case where the company does not want to raise capital through public subscription.

iii. In the case of private placement of shares the allotees will not sell their shares for a minimum period of 3 years from the date of allotment. This period is known as **lock-in period**.

Illustration 2 : (Under Subscription)

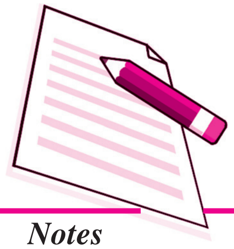
Sukriti Ltd. was registered with an authorised capital of ₹ 10,00,000 divided into shares of ₹ 10 each. Company issued 60,000 shares to public and amount was payable as follows : ₹ 3 on application; ₹ 2 on allotment & ₹ 5 on call

Application for 55000 shares were received, which were allotted. Full amount received on due dates. Pass Journal enteries in the Books of Sukriti Ltd.

Solution :

Journal

Date	*Particulars*	*L.F.*	*₹ (Dr.)*	*₹ (Cr.)*
	Bank A/c Dr. To Share Application A/c (Being Application money received)		1,65,000	 1,65,000



Notes

Date	Particulars	L.F.	₹ (Dr.)	₹ (Cr.)
	Share Application A/c Dr. To Share Capital A/c (Being Application money transferred to share Capital A/c)		1,65,000	1,65,000
	Share Allotment A/c Dr. To Share Capital A/c (Being Allotment money due)		1,10,000	1,10,000
	Bank A/c Dr. To Share Allotment A/c (Allotment money received)		1,10,000	1,10,000
	Share Call A/c Dr. To Share Capital A/c (Share Call money due)		2,75,000	2,75,000
	Bank A/c Dr. To Share Call A/c (Being Call money received)		2,75,000	2,75,000

Illustration 3 : (Over Subscription)

Bhiwani Ltd. issued a prospectus for inviting application from the public for 10,000 equity shares of ₹ 10 each. The amounts were payable as follows:

₹ 2 on Application, ₹ 3 on Allotment & the balance as and when called.

Applications were received for 12,000 shares & the allotment was made as follows: Full Allotment on applications for 8,000 shares; 2,000 shares on applications for 3,000 shares. No allotment was made on applications for 1,000 shares. Pass Journal entries in the books of the company assuming that all allotment money was received and the call was not made.

Journal

Date	*Particulars*	*L.F.*	*₹ (Dr.)*	*₹ (Cr.)*
	Bank A/c Dr. To Share Application A/c (Being application money received for 12000 @ ₹ 2)		24,000	24,000

	Share Application A/c Dr.		24,000	
	To Share Capital A/c			20,000
	To Share Allotment A/c			2,000
	To Bank A/c			2,000
	(Being transfer of application Money to Capital A/c on 10000 shares alloted & refund on application money on 1000 shares received)			
	Share Allotment A/c Dr.		30,000	
	To Share Capital A/c			30,000
	(Being the amount on allotment due)			
	Bank A/c Dr.		28,000	
	To Share Allotment A/c			28,000
	(Being the receipts of allotment money due)			

INTEXT QUESTIONS 26.5

State whether the following statements are true or false :

i. A joint stock company is an artificial person created by law.

ii. The liability of the share holders of the company is unlimited.

iii. Registration is not compulsory in the case of a Joint Stock Company.

iv. Preference shareholders get dividend after the equity shareholders.

26.6 ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

The company purchases certain assets from vendors (sellers or suppliers) on credit. Instead of making payment to vendors in cash, the company issues them certain agreed number of shares at the agreed rate as a consideration (payment in exchange) of assets purchased. Shares may be issued to vendors at par, at premium or at discount. The requisite journal entry to be passed is as under:

On Purchasing the Assets

Particular Asset A/c Dr.
or Sundry Asset A/c Dr. (If name of assets is not given)
    To Vendors A/c
(Being purchase of assets on credit)

Issue of Shares to Vendors

At Par

Vendor A/c Dr.
    To Share Capital A/c
(Being issue of __ number of shares to vendors @ ₹ - Per share)

At Premium

Vendor A/c Dr.
    To Share Capital A/c
    To Securities Premium Reserve

$$\text{No. of Shares} = \frac{\textit{Amount Due}}{\textit{Face Value} + \textit{Premium}}$$

At Discount

Vendor A/c Dr.
Discount on issue of Shares A/c Dr.
    To Share Capital A/c

$$\text{No. of Shares} = \frac{\textit{Amount Due}}{\textit{Face Value} - \textit{Discount}}$$

Illustration 4 : (Issue of Shares for Consideration other than Cash)

The Hindustan Limited was registered with a share capital of ₹ 5,00,000 in ₹100 shares. Pass Journal Entries in the following cases :

i. The company purchased the business of Ram & Company for ₹ 1,50,000 payable ₹ 20,000 in cash and the balance in equity shares of ₹ 100.

ii. The company purchased Building and issued 2,000 shares of ₹ 100 each as purchase consideration.

Solution :

Journal

Date	*Particulars*	*L.F.*	*₹ (Dr.)*	*₹ (Cr.)*
(i)	Sundry Assets A/c Dr.		1,50,000	
	To Ram & Company A/c			1,50,000
	(Being purchase of the business of Ram & Company)			
	Ram & Company A/c Dr.		1,50,000	
	To Bank A/c			20,000
	To Equity Share Capital A/c			1,30,000
	(Being payment to Ram & Company by issue of 1,300 shares of ₹ 100 each and ₹ 20,000 in cash)			
(ii)	Building A/c Dr.		2,00,000	
	To Vendor's A/c			2,00,000
	(Being purchase of Building on credit)			
	Vendor's A/c Dr.		2,00,000	
	To Share Capital A/c			2,00,000
	(Being issue of 2000 shares of ₹ 100 each to vendors)			

Illustration 5

Simran Ltd. purchased assets of Charu Ltd. for ₹ 99,000. The purchase consideration was agreed to be paid in terms of equity shares of Simran Ltd. You are required to pass necessary Journal Entries in the following cases :

i. Shares issued at par of ₹ 10 each.

ii. Shares issued at premium of 10%.

iii. Shares issued at discount of 10%.

Notes

Solution :

Journal

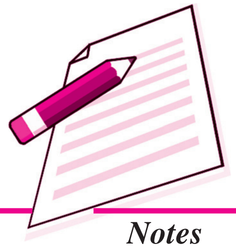
Date	*Particulars*		*L.F.*	₹ *(Dr.)*	₹ *(Cr.)*
	Sundry Assets A/c	Dr.		99,000	
	To Charu Ltd. A/c				99,000
	(Being the purchase of assets from Charu Ltd.)				
(i)	***At Par***				
	Charu Ltd. A/c	Dr.		99,000	
	To Equity Share Capital A/c				99,000
	(Being purchase consideration paid by issue of 9,900 shares at ₹ 10 each)				
(ii)	***At Premium 10%***				
	Charu Ltd. A/c	Dr.		99,000	
	To Equity Share Capital A/c				90,000
	To Securities Premium A/c				9,000
	(Being 9,000 shares issued at ₹ 10 to each at 10% premium to Charu Ltd.)				
(iii)	***At Discount 10%***				
	Charu Ltd. A/c	Dr.		99,000	
	Discount on issue of Equity Shares A/c	Dr.		11,000	
	To Equity Share Capital				1,10,000
	(Being 11000 Equity shares issued of ₹ 10 each at 10% discount to Charu Ltd.)				

Working Notes

i. No. of Shares $= \frac{99,000}{10} = 9,900$ shares

ii. No. of shares $= \frac{99,000}{11} = 9,000$ shares

iii. No. of shares $= \frac{99,000}{9} = 11,000$ shares



26.7 ISSUE OF SHARES TO PROMOTERS

Promoters are those persons, firms or companies, who promote the company. They are entrusted with the work of the formation of the company. Promoters are paid remuneration for their services. This remuneration can be paid in the form of shares also. In such cases companies issue shares to their promoters without payment. The journal entry to be passed is as under :

Goodwill A/c Dr.

To Share Capital A/c

Goodwill A/c is debited on the assumption that promoter's function has resulted in forming the company into profitable unit.

Alternatively, conservative treatment is as under :

Preliminary Exp. / Incorporation Costs A/c Dr.

To Share Capital A/c

Incorporation costs A/c should be written off against P/L Account as early as possible.

Illustration 6 : (Issue of Shares for consideration other than Cash)

ABC Ltd. was registered with a nominal capital of ₹ 10,00,000 divided into shares of ₹ 10 each. The company purchased Machinery for ₹ 27,000 from XYZ Co. Ltd and issued fully paid equity shares of ₹ 10 each in satisfaction of the claim. Shares of ₹ 10,000 were issued at par to the promoters for their services.

Give Journal entries of the above transactions if to XYZ shares were issued (i) at par (ii) at 20% permium & (iii) at 10% discount.

Solution :

Journal

Date	*Particulars*	*L.F.*	*₹ (Dr.)*	*₹ (Cr.)*
A.	**For Purchase of Machinery :**			
	Machinery A/c Dr.		27,000	
	To XYZ Co. Ltd. A/c			27,000
	(Being Machinery purchased from XYZ Co. Ltd)			

(i)	**If Shares are issued at Par :**			
	XYZ Co. Ltd A/c Dr.		27,000	
	To Share Capital A/c			27,000
	(Being 2700 shares of ₹ 10 each issued to XYZ Co. Ltd.)			
(ii)	**If Shares are issued at Premium :**			
	XYZ Ltd. A/c (2250 x 12) Dr.		27,000	
	To Share Capital A/c (2250 x 10)			22,500
	To Securities Premium Reserve(2250 x 2)			4,500
	(Being 2250 shares of ₹ 10 each issues at 20% premium)			
	No. of Shares = 27000 ÷ 12 = 2250			
(iii)	**If Shares are issued at Discount :**			
	XYZ Co. Ltd A/c (3000 x 9) Dr.		27,000	
	Discount on Issue of Shares A/c (3000 x 1) Dr.		3,000	
	To Share Capital A/c (3000 x 10)			30,000
	(Being 3,000 Shares of ₹ 10 each issued at 10% Discount)			
	Hint : No. of Shares = 27,000 9 = 3,000			
B.	**For Issue of Shares to the Promoters :**			
	Goodwill A/c Dr.		10,000	
	To Share Capital A/c			10,000
	(Being Shares issued at par to the promoters)			

INTEXT QUESTIONS 26.6

Choose the correct option :

i. When shares are issued to the vendors at par as consideration of assets purchased, the total value of shares issued will be:

a) More than the purchase consideration.

b) Less than the purchase consideration.

c) Equal to the purchase considerations.

d) None of the above.

Notes

Notes

ii. When shares are issued to the vendors at premiums as consideration of assets purchased, the total value of shares issued will be:

a) Equal to the purchase consideration.

b) More than the purchase considerations

c) Less than the purchase considerations.

d) None of the above

iii. When shares are issued to the vendors at discount as consideration of assets purchased, the total value of shares issued will be:

a) Less than the purchase considerations.

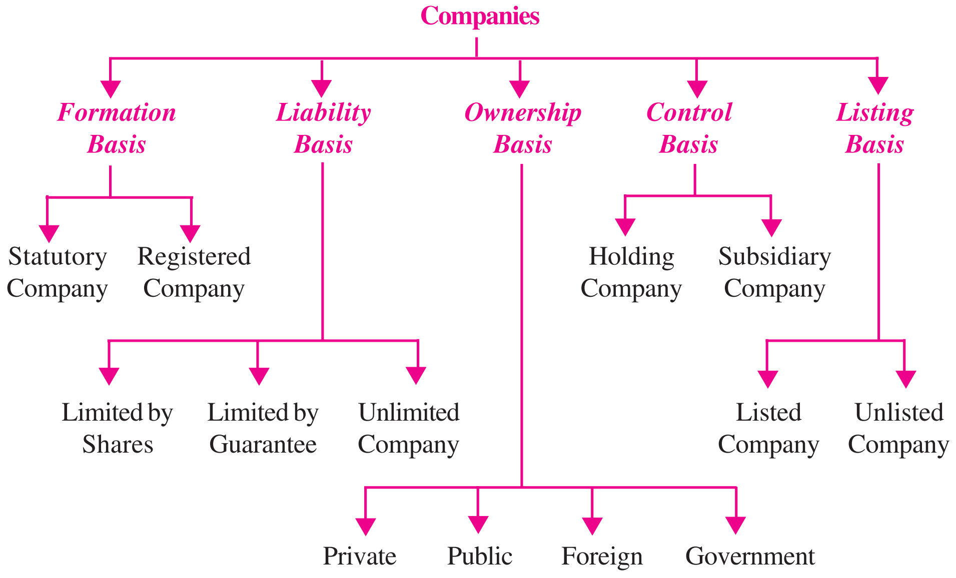
b) More than purchase considerations.

c) Equal to purchase considerations.

d) None of the above

WHAT YOU HAVE LEARNT

- Company is an association of persons who contribute to its capital and is registered under Companies Act, 1956
- Characteristics of a company are : Seperate Legal Entity; Incorporated Body; Perpetual Existence; Limited Liability; Common Seal.
- Types of companies are:



- Private companies are companies which by their Articles of Association
  - (i) Restrict the maximum number of members to fifty
  - (ii) Restrict the transferability of shares
  - (iii) Put restriction on inviting public to buy its shares
  - (iv) Minimum paid up capital of such company is one Lakh rupees.
- Private company must add the words 'Private Limited' as a suffix to its name.
- Companies that are not private companies are public companies.
- Company raises its capital through issue of shares.
- Shares are of two types : Equity shares and preference shares. Preference shares carry preference over other shares with regard to payment of dividend and refund of capital in case of its winding up. Shares other than preference shares are called 'equity shares'.
- Share Capital : Authorised/Nominal; Issued; Subscribed; Called up; Uncalled Paid up; Unpaid; Reserve
- Share : Share means to possess a right on specific amount of Share Capital.
- Types of Shares : Equity Shares and Preference Shares shares may be issued to vendors as purchase considerations for purchase of assets. Such shares can be issued at par, at premium or at discount.
- When shares are issued to a selected lot of people without issuing of prospectus it is called private placement of shares.

TERMINAL EXERCISE

1. Define company. Explain in brief its characteristics.
2. What are preference shares? Distinguish between equity share and preference shares.
3. List the various restrictions on a private company. Distinguish between a public company and a private company.
4. What is share capital? Explain different types of share capital.

5. Explain different types of companies.
6. What is meant by a Joint Stock Company?
7. Explain the characteristics of a company.
8. State the characteristics of equity shares.
9. What is meant by private placement of shares?
10. Describe the features of private placement of shares.
11. Distinguish between equity shares and preference shares.
12. Give the meaning of issue of shares to vendors.
13. What is meant by issue of shares to promoters?

ANSWERS TO INTEXT QUESTIONS

26.1 I. (i) an artificial person (ii) share
(iii) common seal (iv) representative

II. (i) × (ii) √ (iii) × (iv) √

26.2 I. (i) Seven (ii) 51% (iii) one Lakh (iv) outside India

II. (i) private (ii) company limited by shares
(iii) Statutory company (iv) unlimited liability company
(v) Holding company

26.3 (i) share capital (ii) share (iii) Equity shareholders
(iv) Preference shareholders, Equity shareholders

26.4 I. (i) issue of shares (ii) Authorised capital
(iii) Issued capital (iv) Reserve capital

II. (i) Correct (ii) Wrong (iii) Correct (iv) Wrong

26.5 (i) True (ii) False (iii) False (iv) False

26.6 (i) c (ii) c (iii) b

Notes

ACTIVITY

Your father is a shareholder of a company. Every year he receives report from the company. This report is called annual report of the company. After going through the report for a year, find out the following:

1. Name of the company with suffix Ltd. or Private Ltd.
2. Mention the amount of capital :

   (a) Authorised ....

   (b) Issued ....

   (c) Called up ....

   (d) Call in Arrears ....

   (e) Reserve capital ....

27

ISSUE OF SHARES

In the preceding lesson you have studied about the company, its meaning, characteristics and its various types. You are also familiar with share capital, and its various kinds. Share capital is one of the main sources of finance for a company. In this lesson we shall study the procedure of issuing shares for raising capital and its accounting treatment in the books of the company.

OBJECTIVES

After going through this lesson you will be able to

- explain the procedure of isssuing shares;
- explain that the share money may be called in lump sum or in two or more instalments;
- state that shares may be issued at par, at premium, or at discount;
- make journal entries to record the isssue of shares and
- explain the terms calls in arrears and calls in advance.

27.1 PROCEDURE OF ISSUE OF SHARES

Face value of a share is the par value of the share. It is also known as the Nominal value or denomination of a share. To issue shares a company follows a definite procedure which is controlled and regulated by the Companies Act and Securities Exchange Board of India (SEBI). There are different ways of issue of shares which may be:

(A) For consideration other than cash

(B) For cash

(A) ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

Sometimes shares are issued to the promotors of the company in lieu of the services provided by them during the incorporation of the compnay. The issue price of these shares is normally debited to 'Goodwill A/c' and journal entry is made as follows:

Goodwill A/c   Dr.
    To Share Capital A/c

In case a company does not have sufficient funds for the purchase of fixed assets or for payment to creditors it may offer and allot its shares to vendors/ creditors in lieu of cash. Any allotment of shares against which cash is not to be received is called 'issue of shares for consideration other than cash'. For example building is purchased and payment is made by issuing shares.

In case of purchase of assets like building, machinery, stock of materials, etc. the following journal entry is made :

1. Assets A/c   Dr.
        To Vendors/Creditors A/c
    (Assets purchased)

2. Vendors/Creditors A/c   Dr.
        To Share Capital A/c
    (Issue of shares of ₹.......each fullly paid up)

(B) ISSUE OF SHARES FOR CASH

In general, shares are issued for cash. The company may call the share money either in one instalment or in two or more instalments. But company always collects this money through its bankers.

(i) **Receipt of Share Money in One Instalment :** The company may receive the share money in one instalment along with application. In this case the following journal entries are made in the books of the company

1. On Receipt of Application Money
    Bank A/c   Dr.
        To Share Application A/c
    (Application money received on ....shares of ₹...each)

2. On transferring the Application Money

Share Application A/c Dr.

To Share Capital A/c

(Application money transferred to share capital A/c)

(ii) Share Money Received in Two or More Instalments : Instead of receiving payment in one instalment i.e. at the time of application the company collects it in two or more instalments. The first, instalment which the appplicants have to pay along with the applications for shares is known as application money. On the allotment of shares the allottees are required to pay the second instalment which is termed as allotment money. If the company decides to call the share money in more than two instalments the other instalment is/are termed as call money (i.e. first-call, second call or final call).

In the above case the transactions are recorded in journal as given below :

(a) On Receipt of Application Money

Bank A/c Dr.

To Share Application A/c

(Receipt of share application money for …. Shares @ ₹.. per share)

(b) On Allotment of Shares : After receiving the application for shares within the prescribed time, the Board of Directors of the company proceed to allot shares. On allotment of shares the application money is transferred to Share Capital A/c. For this the following journal entry is made :

Share Application A/c Dr.

To Share Capital A/c

(Share application for …. Shares @ ₹… per share transferred to share capital A/c)

Allotment Money Becoming Due and Received

On the allotment of shares the amount receivable on the next instalment i.e. on allotment becomes due. The following entry is made for recording the amount due:

(i) Allotment money becoming due

Share Allotment A/c Dr.

To Share Capital A/c

(Share allotment money due on …. shares @₹ ... per share)

Notes

(ii) Receipt of allotment money

On the receipt of share allotment money the following journal entry is made:

Bank A/c Dr.

To Share Allotment A/c

(Receipt of the amount due on allotment of … shares)

Calls on Shares

After the receipt of application and allotment money the money that remains unpaid can be called up by the company as and when required. Thus a call is a demand made by the company asking the shareholders to remit the called up amount on shares allotted to them.

The company may demand the remaining money in more than two instalments. The amount called after the allotment is known as call money. There may be one or more calls, depending on the fund requirements of the company. When only **one** call is made and Call Money is Due :

Share First and Final Call A/c Dr.

To Share Capital A/c.

(Call money due on …. share @ ₹ … per share).

Receipt of Call Money

The following journal entry is made for receipt of call money:

Bank A/c Dr.

To Share First & Final call A/c

(call money due on … shares @ ₹ ... per share received)

Note : If the company makes more than one call the same accounting treatment is followed for recording the second call or third call money due and their receipt. The last call made is termed as final call.

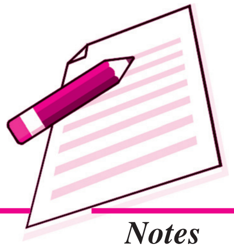
Illustration 1

Fashion Fabrics Ltd. issued 100000 shares of ₹ 10 each on 1st April, 2014. The amount payable on these shares was as under:

₹ 2 per share on application.

₹ 3 per share on allotment.

₹ 5 per share on call.



Notes

Make journal entries and prepare relevant accounts in the books of company.

Solution :

Fashion Fabrics Ltd.
Journal Entries

S.No.	*Particulars*	*L.F*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr. To Share Application A/c (Application money received @ ₹ 2 per share)		2,00,000	2,00,000
2.	Share Application A/c Dr. To Share Capital A/c (Share application money for 100000 shares transferred to share capital A/c)		2,00,000	2,00,000
3.	Share Allotment A/c Dr. To Share Capital A/c. (Allotment money made due on 100000 shares @ ₹ 3/- per share)		3,00,000	3,00,000
4.	Bank A/c Dr. To Share Allotment A/c. (Allotment money received on 100000 shares @ ₹ 3 per share.)		3,00,000	3,00,000
5.	Share First & Final call A/c. Dr. To Share Capital A/c (Call money on 1,00,000 share @ ₹ 5 per share made due)		5,00,000	5,00,000
6.	Bank A/c Dr To Share First & Final call A/c. (Call money received on 1,00,000 shares @ ₹ 5 per share)		5,00,000	5,00,000

Note : Although shares may be equity shares or preference shares but if the term shares is used it means equity shares)

Relevant Accounts

Bank A/c

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Application A/c		2,00,000		Balance c/d		10,00,000
	Share Allotment A/c		3,00,000				
	Share First and Final Call A/c		5,00,000				
			10,00,000				10,00,000
	Balance b/d		10,00,000				

Share Application A/c

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		2,00,000		Bank A/c		2,00,000
			2,00,000				2,00,000

Share Capital A/c

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Balance cld		10,00,000		Share Applicaiton A/c		2,00,000
					Share Allotment A/c		3,00,000
					Share First and Final call A/c		5,00,000
			10,00,000				10,00,000
					Balance b/d		10,00,000

Share Allotment A/c

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		3,00,000		Bank A/c		3,00,000
			3,00,000				3,00,000

Share First and Final Call A/c

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		5,00,000		Bank A/c		5,00,000
			5,00,000				5,00,000

Notes

INTEXT QUESTIONS 27.1

Fill in the blanks with appropriate word/words :

(i) Face value of share is .... value of the share.

(ii) Shares in consideration other than cash are issued to ....

(iii) Share money on issued shares can be demanded by the company in lump sum or in ....

(iv) Share application money is received by the company from share ....

27.2 FULL, UNDER AND OVER SUBSCRIPTION

A company decides to issue number of shares to raise capital. It invites public to buy these shares. Now there may be three situations :

I. Full Subscription : Company may receive applications equal to the number of shares company has offered to people. It is called full subscription. In case of full subscription the journal entries will be made as follows :

(a) On receipt of application money
Bank A/c Dr
To Share Application A/c
(Application money received for .... shares)

(b) On allotment of shares
Share Application A/c Dr
To Share Capital A/c
(Application money of shares transferred to capital A/c on their allotment)

II. The company does not receive applications equal to the number of shares offered for subscription, there may be two situations : (i) under subscription; (ii) over subscription

Notes

(i) ***Under Subscription :*** The issue is said to have been under subscribed when the company receives applications for less number of shares than offered to the public for subscription. In this case company is not to face any problem regarding allotment since every applicant will be alloted all the shares applied for. But the company can proceed with allotment provided the subscription for shares is at least equal to the minimum required number of shares termed as minimum subscription.

(ii) ***Over Subscription :*** When company receives applications for more number of shares than the number of shares offered to the public for subscription it is a case of over subscription. A company cannot allot more shares than what it has offered. In case of over subscription, company has the following options :

Option I

(i) ***Rejection of Excess Applications and Money Returned :*** The company may reject the applications for shares in excess of the shares offered for issue and a letter of rejection is sent to such applicants. In this case the application money received from these applicants is refunded to them in full. The journal entry made is as follows:

Share Application A/c Dr.
    To Bank A/c
(Application money on … shares refunded to the applicants)

(ii) ***Excess application money adjusted towards sums due on allotment. Journal entry made is :***

Shares Application A/c Dr.
    To Share Allotment A/c
(Excess application money adjusted towards sums due on allotment)

If the application money received on partially accepted applications is more than the amount required for adjustment towards allotment money, the excess money is refunded. However, if the Articles of the company so authorise, the directors may retain the excess money as calls in advance to be adjusted against the call/ calls falling due later on and the following entry is made :

Share Application A/c Dr.
    To Call-in-advance A/c
(The adjustment of excess share application money retained as call-in-advance in respect of ... shares)

Option II

Partial Acceptance of Applications

In some cases the company accepts the applications for subscription partially. It means that the company does not allot the full number of shares applied for. For example if an applicant has applied for 5000 shares and is allotted only 2000 shares, then the applications is said to have been partially accepted. The company may evolve some formula of accepting applications partially or making proportionate allotment/ the Prorata allotment which means that the applicants are allotted shares proportionately. In such a case the company adjusts the excess share money received on application towards share allotment money due on partially accepted applications. The journal entry recording the adjustment of application money towards share allotment money, is as under :

Share Application A/c Dr.

To Share Allotment A/c

(Share application money transferred to Share Allotment Account in respect of ... shares)

Illustration 2

The Full Health Care Ltd has offered to public for subscription 20000 shares of ₹ 100 each payable as ₹ 30 per share on application, ₹ 30 per share on allotment and the balance on call. Applications were received for 30000 shares. Applications for 5000 shares were rejected all together and application money was returned. Remaining applicants were alloted the offered shares. Their excess application money was adjusted towards some due on allotment. Calls were made and duly received. Make journal entries in the books of the company.

Solution :

Full Health Care Ltd.

Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr. To Share Application A/c (Application money received for 30000 shares @ ₹ 30 per share)		9,00,000	9,00,000

Notes

2.	Share Application A/c Dr.		9,00,000	
	To Share Capital A/c			6,00,000
	To Bank A/c			1,50,000
	To Share Allotment A/c			1,50,000
	(Application money of 20000 shares transferred to share capital A/c on their allotment. That of 5000 shares returned and of 5000 shares adjusted towards sum due on allotment)			
3.	Share Allotment A/c Dr.		6,00,000	
	To Share Capital A/c.			6,00,000
	(Allotment money due)			
4.	Bank A/c Dr.		4,50,000	
	To Share Allotment A/c.			4,50,000
	(Allotment money received)			
5.	Share First and Final call A/c. Dr.		8,00,000	
	To Share Capital A/c			8,00,000
	(Call money due)			
6.	Bank A/c Dr.		8,00,000	
	To Share First and Final call A/c.			8,00,000
	(Call money received)			

INTEXT QUESTIONS 27.2

Fill in the blanks with appropriate word or words in the following sentences:

(i) When company receives applications for more number of shares than offered for subscription it is a case of ....

(ii) When share money is to be received in two or more instalments the first instalment is called ....

(iii) Call is a demand made by the company asking the shareholders to pay the .... amount.

(iv) A company .... allot more shares than it has issued.

27.3 ISSUE OF SHARES AT PREMIUM

A company can issue its shares at their face value. When company issues its shares at their face value, the shares are said to have been issued at par. Company can also issue its shares at more than or less than its face value i.e, at 'Premium' or at 'Discount' respectively. When shares are issued at premium or at discount an accounting treatment different from shares issued at par is required. Let us discuss issue of shares at premium.

Issue of Shares at Premium

If a company issues its shares at a price more than its face value, the shares are said to have been issued at Premium. The difference between the issue price and face value or nominal value is called 'Premium'. If a share of ₹ 10 is issued at ₹ 12, it is said to have been issued at a premium of ₹ 2 per share. The money received as premium is transferred to Securities Premium A/c. A company issues its shares at premium only when its financial position is very sound. It is a capital gain to the company. The Premium money may be demanded by the company with application, allotment or with calls.

The Companies Act has laid down certain restrictions on the utilisation of the amount of premium.

According to Section 78 of this Act, the amount of premium can be utilised for :

(i) Issuing fully-paid bonus shares;

(ii) Writing off preliminary expenses, discount on issue of shares and debentures, underwriting commission or expenses on issue;

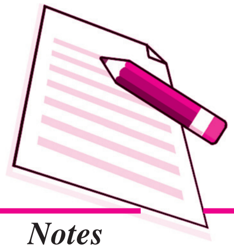
(iii) Paying premium on redemplion of Preference shares or Debentures;

(iv) By Back of Shares.

Further, the company may demand the total amount of premium in more than one instalment. In case the company doesn't specify the particular call with which Securities Premium is to be paid it is supposed to be called at the time of Allotment.

Accounting Treatment of Premium on Issue of Shares

Following is the accounting treatment of Premium on issue of shares :



Notes

(a) Securities Premium Collected with Share Application Money : If the Securities premium is collected on application and the company has taken decision about the allotment of shares, the following journal entry is made :

Share Application A/c Dr.
To Securities Premium A/c
(The amount of Securities premium received on application of the alloted shares is transferred to Securities Premium A/c)

(b) Premium Collected with Allotment Money or Calls : If the company decides to demand the premium with share Allotment or/and share call money, the journal entry made is :

Share Allotment A/c Dr.
Or/and
Share Call A/c Dr.
To Securities Premium A/c
(Adjustment of share premium due on……shares @ ₹…….per share.)

Illustration 3

Luxuary Cars Ltd. issued 100000 shares of ₹ 10 each at a premium of ₹ 5 per share, payable as:

On application	₹ 4 (including ₹ 2 premium) per share
On allotment	₹ 8 (including ₹ 3 premium) per share
On call	₹ 3 per share

Applications were received for 100000 shares and allotment was made to all. Make journal entries.

Solution :

Books of Luxury Cars Ltd.

Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr. To Share Application A/c (Amount received for 1,00,000 shares)		4,00,000	 4,00,000

Notes

2.	Share Application A/c Dr. To Share Capital A/c To Securities Premium A/c (Share application money transferred to share capital A/c and securities Premium A/c)		4,00,000	 2,00,000 2,00,000
3.	Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c (Share allotment money made Due)		8,00,000	 5,00,000 3,00,000
4.	Bank A/c Dr. To Share Allotment A/c (Share allotment money is received on 1,00,000 shares @ ₹ 8 per share)		8,00,000	 8,00,000
5.	Share First and Final Call A/c Dr. To Share Capital A/c (Share call money made due on 1,00,000 shares @ ₹ 3 per share.)		3,00,000	 3,00,000
6.	Bank A/c Dr. To Share First and Final Call A/c (Share call money received on 1,00,000 shares @ ₹ 3 per share.)		3,00,000	 3,00,000

INTEXT QUESTIONS 27.3

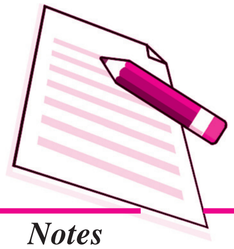
Fill in the blanks with suitable word/words and figure/figures :

(i) Securities premium is a .... to the company.

(ii) If allotment money demanded is ₹ 5 per share including ₹ 2 for premium. the share capital account will be credited by ₹ ....

(iii) A company issues its shares of ₹ 50 each at ₹ 60 per share. The excess money of ₹ 10 each is ....

(iv) If the premium per share is ₹ 20 on a share of ₹ 100 each, the share capital A/c will be credited with .... per share.



Notes

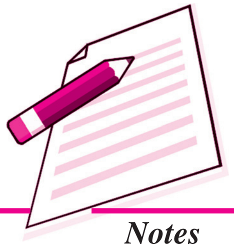
Illustration 4

Sunita Ltd. was registered with an authorised capital of ₹ 50,00,000 divided in 50,000 shares of ₹ 100 each. Company issued 20,000 shares at a premium of ₹ 20 per share. Amount receivables as ₹ 40 on application, ₹ 40 on allotment (including premium) ₹ 20 on first call & ₹ 20 on second & final call. All shares were subscribed & all money was duly received. Share issue expenses amounted to ₹ 20,000 which were fully written off against securities premium reserve A/c. Pass necessary Journal entries & Prepare Bank A/c, Security Premium A/c and Balance Sheet.

Solution :

Journal

	Particulars	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Bank A/c Dr.		8,00,000	
	To Share Application A/c			8,00,000
	(Being application money received for 20000 shares @ ₹ 40 per share)			
	Share Application A/c Dr.		8,00,000	
	To Share Capital A/c			8,00,000
	(Being application money transferred to Share Capital A/c)			
	Share Allotment A/c Dr.		8,00,000	
	To Share Capital A/c			4,00,000
	To Securities Premium Reserve A/c			4,00,000
	(Being allotment money due with premium)			
	Bank A/c Dr.		8,00,000	
	To Share Allotment A/c			8,00,000
	(Being allotment money received with premium)			
	Share First Call A/c Dr.		4,00,000	
	To Share Capital A/c			4,00,000
	(Being First Call due @ ₹ 20 per share)			



	Bank A/c Dr.		4,00,000	
	To Share First Call A/c			4,00,000
	(Being First call money received)			
	Share Second & Final Call A/c Dr.		4,00,000	
	To Share Capital A/c			4,00,000
	(Being Second Call due @ ₹ 20 per share)			
	Bank A/c Dr.		4,00,000	
	To Share Second & Final Call A/c			4,00,000
	(Being Second call money received)			
	Share Issue Expenses/Preliminary Expenses A/c Dr.		20,000	
	To Bank A/c			20,000
	(Being expenses incurred on issue of shares)			
	Securities Premium Reserve A/c Dr.		20,000	
	To Share issue Expenses A/c			20,000
	(Being share issue expenses written off against securities premium account)			

Bank Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Share Application A/c	8,00,000	By Share Issue Exp. A/c	20,000
To Share Allotment A/c	8,00,000	By Balance c/d	23,80,000
To Share First Call A/c	4,00,000		
To Share Second Call A/c	4,00,000		
	24,00,000		24,00,000

Securities Premium Reserve Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Share Issue Exp. A/c	20,000	By Share Allotment A/c	4,00,000
To Balance c/d	3,80,000		
	4,00,000		4,00,000

Balance Sheet of Sunita Ltd.
as at ....

Particulars	*Note*	₹
I. Equity & Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	20,00,000
(b) Reserve and Surplus	2	3,80,000

Note 1

Share Capital

Authorised Capital	
50000 shares of ₹ 100 each	50,00,000
Issued Capital	
20000 shares of ₹ 100 each	20,00,000
Subscribed	
Subscribed & Fully Paid up	
20000 shares of ₹ 100 each	20,00,000

Note 2

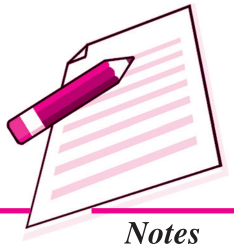
Reserves & Surplus : Securities Premium Reserve	3,80,000

Dislosure of Share Capital in Company's Balance Sheet (Vertical form)

According to schedule V1, Part I of the companies Act 1956, the Share Capital of a company is shown in the Balance Sheet as given below.

Balance Sheet of a Company (an extract)
as at ....

Particulars	*Note*	₹
I. Equity and Liabilities		
(1) Shareholders Funds		
(a) Share Capital		
(b) Reserves and Surplus		
(c) Money received against share accounts		
(2) Share Application Money Pending Allotment		



Notes

Note : On the face of the Balance Sheet only so much information should be disclosed as is required and the remaining should be disclosed in the Notes to Accounts.

I. Equity and Liabilities

There are broadly two headings shown on the Equity and Liabilities side. First, being the equity, *i.e.,* liability of the company towards shareholders. It is termed as Shareholders' Funds. It includes Share Capital, Reserves and Surplus and Money received against share warrants. Second, being liability of the company towards the outsiders. It is termed as Liabilities.

1. Shareholders' Funds

(a) ***Share Capital :*** It is the first item under shareholders' funds. Details required to be shown are :

i.
- *Authorised Share Capital :* Authorised Share Capital is stated in the Memorandum of Association and is divided into different categories such as **equity share capital and perference share capital**. It is the amount of share capital that a company is authorised to issue under each category. It is shown by way of information in the notes attached to the Balance Sheet. The above information is shown for information only, *i.e.,* it is not added to liability.
- *Issued Share Capital :* It is that part of the authorised share capital which the company has issued for subscription up to the authorised share capital which the company has issued for subscription up to the date of Balance Sheet. It includes a number and classes (Equity or Preference) of shares and their face value, etc.
- *Subscribed Share Capital :* It is that part of issued share capital which has been subscribed by the applicants.
- *Called-up Share Capital:* It is that part of the issued share capital that has been called-up to be paid by the company.
- *Paid-up Share Capital :* It refers to that part of subscribed share capital which has been paid-up by the subscriber towards share capital.

(ii) If a company has issued different types of Equity and Preference shares, detail of each type of shares is given.

(iii) Amount of Calls-in-Arrear is shown as deduction from called-up capital or 'subscribed capital' to ascertain the paid-up capital of the company and shown as liability in the Balance Sheet.

Calls-in Arrear from Directors and Officers of the company have to be disclosed.

(iv) Forfeited shares amount, *i.e.,* amount originally paid up is shown by adding it to subscribed capital. But in case of profit on reissue of forfeited shares, it is transferred to Capital Reserves.

It is to be noted that details regarding share capital or in fact, any item of Balance Sheet and Statement of Profit and Loss is to be given in the notes.

(b) ***Reserve and Surplus :*** Reserve and Surplus include following items and are shown separately :

(i) Capital Reserves

(ii) Capital Redemption Reserve

(iii) Securities Premium Reserve

(iv) Debentures Redemption Reserve

(v) Revaluation Reserves

(vi) Share Options Outstanding Account

(vii) Other Reserves (to specify the nature and purpose of each reserve)

(viii) Balance in the statement of Profit and Loss after appropriations towards proposed dividend and transfer to reserves. In case, Reserves and Surplus has a balance under the head, profit (surplus) or loss (deficit) for the year is added to it. Thereafter, appropriation is made by transfer to reserves or for provision for dividend.

If the balance after transfer of profit to the existing balance results in negative figure, it is shown under Reserves and Surplus as a negative amount. It means it is deducted to arrive at the total reserves.

The balance of the reserve and surplus, whether positive or negative, is shown under shareholders funds.

Notes

Illustration 5

ABC Ltd invited applications for issuing 80,000 equity shares of ₹ 10 each. Money is payable as follows :

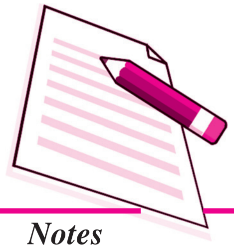
₹ 3 on Application, ₹ 3 on Allotment, ₹ 2 on First Call and ₹ 2 on Second & Final call.

All the shares were applied and all sums due on allotment and calls have been received. Share issue expenses amounted to ₹ 8,000. You are required to prepare Journal, Ledger Accounts and the Balance Sheet of ABC Ltd.

Solution :

Journal

	Particulars	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Bank A/c Dr. To Share Application A/c (Being application money received for 80000 shares @ ₹ 3 per share)		2,40,000	2,40,000
	Share Application A/c Dr. To Share Capital A/c (Being application money transfered to Share capital A/c)		2,40,000	2,40,000
	Share Allotment A/c Dr. To Share Capital A/c (Being allotment money due on 80,000 shares @ ₹ 3 per share)		2,40,000	2,40,000
	Bank A/c Dr. To Share Allotment A/c (Being allotment money received)		2,40,000	2,40,000
	Share First Call A/c Dr. To Share Capital A/c (Being First Call due on 80,000 shares @ ₹ 2 per share)		1,60,000	1,60,000



Notes

	Bank A/c Dr.		1,60,000	
	To Share First Call A/c			1,60,000
	(Being amount received on first call)			
	Share Second & Final Call A/c Dr.		1,60,000	
	To Share Capital A/c			1,60,000
	(Being amount received on final call)			
	Share Issue Expenses A/c Dr.		8,000	
	To Bank A/c			8,000
	(Being expenses incurred on issue of shares)			

LEDGER

Bank Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Share Application A/c	2,40,000	By Share Issue Exp. A/c	8,000
To Share Allotment A/c	2,40,000	By Balance c/d	7,92,000
To Share First Call A/c	1,60,000		
To Share Final Call A/c	1,60,000		
	8,00,000		8,00,000

Share Application Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Share Capital A/c	2,40,000	By Bank A/c	2,40,000
	2,40,000		2,40,000

Share Allotment Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Share Capital A/c	2,40,000	By Bank A/c	2,40,000
	2,40,000		2,40,000

Share First Call Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Share Capital A/c	1,60,000	By Bank A/c	1,60,000
	1,60,000		1,60,000

Notes

Share Final Call Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Share Capital A/c	1,60,000	By Bank A/c	1,60,000
	1,60,000		1,60,000

Share Capital Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Balance c/d	8,00,000	By Share Application A/c	2,40,000
		By Share Allotment A/c	2,40,000
		By Share First Call A/c	1,60,000
		By Share Final Call A/c	1,60,000
	8,00,000		8,00,000

Share Issue Expense Account

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Bank A/c	8,000	By Balance c/d	8,000
	8,000		8,000

Balance Sheet of ABC Ltd (An Extract)

as at

Particulars	*Note*	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	8,00,000
II. Assets		
(1) Non Current Assets		
(a) Other non current assets	2	8,000

Note 1

Share Capital

Authorised Capital

………Shares of ₹ 10 each ……………..

Issued Capital

80000 shares of ₹ 10 each	8,00,000

Subscribed

Subscribed & Fully Paid up

80000 shares of ₹ 10 each	8,00,000

Note 2

Share Issue Expenses	8,000

27.4 ISSUE OF SHARES AT DISCOUNT

When the issue price of share is less than the face value, shares are said to have been issued at discount. For example if a company issues its shares of ₹ 100 each at ₹ 90 each, the shares are said to be issued at discount. The amount of discount is ₹ 10 per share (i.e. ₹ 100 – ₹ 90). Discount on issue of shares is a loss to the company.

Section 79 of Companies Act 1956 has laid down certain conditions subject to which a company can issue its shares at a discount. These conditions are as follows :

(i) At least one year must have elapsed from the date of commencement of business;

(ii) Such shares are of the same class which has had already been issued;

(iii) The company has sanctioned such issue by passing a resolution in its General meeting and the approval of the court is obtained.

(iv) Discount should not be more than 10% of the face value of the share and if the company wants to give discount more than 10%, it will have to obtain the sanction of the Central Government.

Accounting Treatment of Shares Issued at Discount

The amount of discount is generally adjusted towards share allotment money and the following journal entry is made:

Share Allotment A/c	Dr.
Discount on issue of shares A/c	Dr.
To Share Capital A/c	
(Allotment money due on....shares @ ₹ ......per share after allowing discount @ ₹ ....per share)	

Illustraion 6

Sri Krishna Agro Chemical Ltd. was registered with a capital of ₹ 5000000 divided into 50,000 shares of ₹ 100 each. It issued 10000 shares at a discount of ₹ 10 per share, payable as :

₹ 40 per share on application

₹ 30 per share on allotment

₹ 20 per share on call.

Company received applications for 15000 shares. Applicants for 12000 shares were allotted 10000 shares and applications for the remaining shares were sent letters of regret and their application money was returned. Call was made. Allotment and call money was duly received. Make journal entries in the books of the company.

Notes

Solution :

Sri Krishna Agro Chemicals Ltd
Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1	Bank A/c Dr.		6,00,000	
	To Share Application A/c			6,00,000
	(Application money received for 15000 shares @ ₹ 40 per Share)			
2.	Share Application A/c Dr.		4,00,000	
	To Share Capital A/c			4,00,000
	(Application money for 10000 shares transferred to share Capital A/c on their allotment)			
3.	Share Application A/c Dr.		2,00,000	
	To Share Allotment A/c			80,000
	To Bank A/c			1,20,000
	(Application money of 3000 shares returned and for 2000 shares adjusted towards sum due on allotment)			

Notes

4.	Share Allotment A/c	Dr.		3,00,000	
	Discount on Issued of Shares A/c	Dr.		1,00,000	
	To Share Capital A/c.				4,00,000
	(Allotment money due)				
5.	Bank A/c	Dr.		2,20,000	
	To Share Allotment A/c				2,20,000
	(Allotment money received)				
6.	Share First & Final Call A/c	Dr.		2,00,000	
	To Share Capital A/c				2,00,000
	(Amount due on call)				
7.	Bank A/c	Dr.		2,00,000	
	To Share First & Final Call A/c				2,00,000
	(Call money received)				

INTEXT QUESTIONS 27.4

Fill in the blanks with suitable word/words :

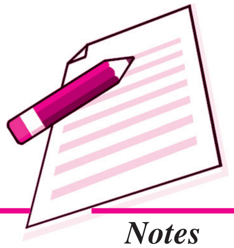
(i) Discount on issue of shares is a .... to the company.

(ii) A company issues its shares of ₹ 100 each at a discount of 10%, money receivable on each share is ....

(iii) If discount per share is ₹ 5 on shares of ₹ 100 each, the share capital A/c will be credited with ₹ ....

27.5 CALLS IN ADVANCE AND CALLS IN ARREARS

If a shareholder pays any amount to company before it is demanded, it is called Call-in-Advance. This amount is put in a separate account known as Calls-in-Advance A/c. This amount is not shown as capital of the company, till such time the company makes a demand from all the shareholders. Call-in-Advance A/c is shown on the liabilities side of the Balance Sheet. For example if a company issued shares of ₹ 10 on which it has already called ₹ 5. Against the uncalled portion of ₹ 5 per share the company makes a call ₹ 3 per share, the entry for call money due will be made only for ₹ 3 per share. Now suppose a shareholder pays ₹ 5 per share including the uncalled amount of ₹ 2 per share along with the call money, it means he has paid ₹ 2 per share in advance, which will be credited to calls in Advance A/c. The company is required to pay interest on this amount @ 6% till the date of its appropriation.



Notes

Accounting Treatment

Following journal entry is made for calls-in-advance.

Bank A/c Dr.

To Calls-in-Advance A/c

(Calls in advance received on…….shares @ ₹ …….per share)

Appropriation of calls-in-Advance A/c say in the final call

Journal entry will be :

Calls-in-Advance A/c Dr.

To Share Final call A/c

(Calls in advance amount adjusted)

For interest given on Calls-in-Advance

ournal entry will be :

Interest on calls-in-Advance A/c Dr.

To Bank A/c

(Interest paid on the amount of Call-in-Advance)

Illustration 7

India Software Ltd. offered 50000 shares of ₹ 10 each to the public payable as:

₹ 2 on application

₹ 3 on allotment

₹ 2 on First call and the balance as and when required.

All the shares were applied for and duly allotted but Mukesh a shareholder holding 200 shares paid the entire balance on allotment.

Make necessary journal entries.

Solution :

India Software Ltd.
Journal Entries

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Bank A/c Dr. To Share Application A/c (Share application money received for 50000 shares @ ₹ 2 per share)		1,00,000	1,00,000

Notes

	Share Application A/c Dr. To Share Capital A/c (Share application money transferred to share capital A/c on allotment)		1,00,000	 1,00,000
	Share Allotment A/c Dr. To Share Capital A/c (Share allotment money made due on 50000 shares @ ₹ 3 per share.)		1,50,000	 1,50,000
	Bank A/c. Dr. To Share Allotment A/c To Call-in-Advance A/c (Amount received on allotment @ ₹ 3 per share and advance for 200 shares @ ₹ 5 per share)		1,51,000	 1,50,000 1,000
	Share First Call A/c Dr. To Share Capital A/c (Share first call money due on 50000 shares @ ₹ 2 per share.)		1,00,000	 1,00,000
	Bank A/c Dr. Call-in-Advance A/c Dr. To Share First call A/c (First call money received on 49800 shares and on 200 shares call in advance is adjusted.)		99,600 400	 1,00,000

Calls in Arrears

When the company sends notice to the shareholders to pay allotment and /or call money, it has to be paid by them within the specified time period. If it is not paid by any one or more of the shareholders, the unpaid amount becomes arrears due from them. Such arrears are transferred to an account termed as Calls-in-Arrears A/c. The company is authorised to charge interest on calls-in-Arrears @ 5% p.a. for the intervening peroid. (The period between date of non-receipt of the due amount and the date of actual receipt of the due amount).

Accounting Treatment

The following jounal entry is made to record Calls-in-Arrears:

Calls-in-Arrears A/c Dr.

To Share Allotment/Call A/c

(Share allotment/ Call money not received on …. shares)

When the unpaid balance is received later on the following journal entry is made:

Bank A/c Dr.

To Calls in Arrears A/c

(Amount due on allotment/ call remaining unpaid now received on…… shares.)

The company may charge interest on the amount of calls in arrears at a given rate from the date of amount due till it is paid journal entry will be

Bank A/c Dr.

To Interest on calls in arrears A/c

Illustration 8

X Ltd. made its first call of ₹ 20 per share on 1st July 2014. Zahir holding 200 shares failed to pay the call money. He could pay the money only on 31st December, 2014. Company charged interest @12% per annum.

Make necessary journal entry for the interest charged by the company.

Solution :

Amount of interest due $4000 \times \frac{12}{100} \times \frac{6}{12} = 240$

Journal Entry

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		240	
	To Interest on call in Arrears A/c			240
	(Receipt of interest on calls in arrears)			

Illustration 9

ABC Ltd issued 20000 shares of ₹ 10 each payable as ₹ 2 per share on application, ₹ 5 (including premium of ₹ 2 per share) on allotment, ₹ 3 per share on first call and the balance on Final Call.

All the money was received except the first call money on 400 shares; which was received later on with final call.

Make necessary journal entries.

Solution :

Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1	Bank A/c Dr.		40,000	
	To Share Application A/c			40,000
	(Application money received for 20000 shares @ ₹ 2 per Share)			
2.	Share Application A/c Dr.		40,000	
	To Share Capital A/c			40,000
	(Application money of 20000 shares transferred to share Capital A/c on allotment)			
3.	Share Allotment A/c Dr.		1,00,000	
	To Share Capital A/c			60,000
	To Securities Premium A/c			40,000
	(Allotment money due with premium @ ₹ 5 (3+2) per share on 20000 shares)			
4.	Bank A/c Dr.		1,00,000	
	To Share Allotment A/c			1,00,000
	(Share allotment money received)			
5.	Shares First Call A/c Dr.		60,000	
	To Share Capital A/c			60,000
	(Share first call money due on 2000 shares @ ₹ 3 per share)			

6	Bank A/c Dr. Calls-in-Arrears A/c Dr. To Share First Call A/c (First call money received on 19600 shares @ ₹ 3 per share.)		58,800 1,200	 60,000
7.	Share Final Call A/c Dr. To Share Capital A/c (Final Call money due on 20000 shares @ ₹ 2 per share.)		40,000	 40,000
8.	Bank A/c Dr. To Share Final Call A/c To Calls-in-Arrears A/c (Final Call money received on 20000 shares @ ₹ 2 per share along with arrears of first call on 400 shares)		41,200	 40,000 1,200

Notes

Illustration 10

The Progressive Industries Limited was registered with a capital of ₹ 50,00,000. It issued 20000 equity shares of ₹ 100 each payable as ₹ 25 on application, ₹ 25 on allotment and balance on 1st and final call and 10000, 9% preference shares of ₹ 100 each payable as ₹ 50 on application and allotment and the balance on two calls of ₹ 25 each. All the shares were applied for and allotted. All money was duly received. Make necessary journal entires in the books of the company :

Solution :

Progressive Industries Ltd
Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr. To Equity Share Application A/c To 9% Preference Share Application and Allotment A/c (Application money received for 20000 equity shares @ ₹ 25 per Share and 10000 9% preference shares @ ₹ 50 per share)		10,00,000	 5,00,000 5,00,000

Notes

2.	Equity Share Application A/c Dr.		5,00,000	
	9% Preference Share Applicaiton & Allotment A/c Dr.		5,00,000	
	To Equity Share Capital A/c			5,00,000
	To 9% Preference Share Capital A/c			5,00,000
	(Applicaiton money transferred to capital accounts)			
3.	Equity Share Allotment A/c Dr.		5,00,000	
	To Equity share Capital A/c			5,00,000
	(Allotment money due on 20000 equity shares at ₹ 25 per share			
4.	9% Preference share 1st call A/c Dr.		2,50,000	
	To 9% Preference Share Capital A/c			2,50,000
	(1st call money due on 10000 9% preference shares at ₹ 25 per share			
5.	Bank A/c Dr.		7,50,000	
	To Equity Share Allotment A/c			5,00,000
	To 9% Preference Share 1st call A/c			2,50,000
	(Equity share allotment money and 9% preference share 1st call money received)			
6.	Equity Share First & Final Call A/c Dr.		10,00,000	
	9% Preference Share Final Call A/c Dr.		2,50,000	
	To Equity Share Capital A/c			10,00,000
	To 9% Preference Share Capital A/c			2,50,000
	(First & Final call on equity shares and Final call on 9% preference shares due)			
7.	Bank A/c Dr.		1,25,0000	
	To Equity Share First & Final Call A/c			10,00,000
	To 9% Preference Share Fianl Call A/c			2,50,000
	(Equity share 1st and final call and 9% Preference share final call money received)			

INTEXT QUESTIONS 27.5

Fill in the blanks with suitable word/words and figure/figures:

(i) The call money demanded by the company if not paid by a shareholder, will be debited to ……………….A/c.

(ii) A shareholder pays ₹ 6 per share on allotment which includes ₹ 2 per share for the next call, extra amount paid is ………………. .

(iii) Interest carged by the company on the amount of calls-in-arrears will be credited to ....

(iv) Interest allowed on the call paid in advance will be debited to ....

WHAT YOU HAVE LEARNT

- Face value of a share is its par value. Shares can be issued for considerations other than cash i.e., for purchase of assets or payment to creditors or promoters.
- Share money can be collected in lump sum or in instalment.
- The first instalment is termed as Share Application money and second instalment is known as Share Allotment money.
- In case share money is collected in more than two instalments this is call money.
- Applications for shares may be received equal to the number of shares offered, (full subscription) less than number of shares offered (under subscription) or for more than the number of shares offered (over subcription)
- When shares are issued at more than their face value these are said to be issued at premium. The premium amount can be utilised only for purposes as specified under section 78 of Companies Act.
- When issue price of a share is less than its nominal value, it is said to be issued at discount. Section 79 of Companies Act has laid down certain conditions to be fulfilled while issuing shares at discount.
- If a shareholder fails to pay Share Allotment money or share call money when demanded by the company, the unpaid amount is called calls in Arrears. If a shareholder pays the amount for calls not made, the amount paid is known as Call-in-Advance.

Notes

TERMINAL EXERCISE

1. What is meant by over subscription of shares? What accounting treatment is given to the amount over subscribed?
2. What is meant by 'Shares Issued at Premium? State the purposes for which Premium amount can be utilised.
3. What is meant by issue of shares at discount? State the conditions to be fulfilled for the issue of shares at discount under the Companies Act.
4. Explain in brief the terms:

   (i) Calls-in Arrears. (ii) Calls-in Advance
5. Make journal entries:

   (a) XY Limited whose share capital is divided into 20,000 equity shares of ₹ 10 each, issued 6,000 shares to the public. The entire money is payable along with the application. All the shares were subscribed and application money was received.

   (b) A Limited issued 10,000 equity shares of ₹ 100 each, payable ₹ 25 per share on application, ₹ 25 per share on allotment, and ₹ 25 on each of the two subsequent calls. All the money was duly received.

   (c) X Ltd., issued 10,000 shares of ₹ 10 each at ₹ 15 payable ₹ 3 on application, Rs. 8 on allotment (including the premium of ₹ 5) and ₹ 4 on call. All the shares are subscribed, allotted and paid for at due dates.

   (d) A limited issued 10,000 shares of ₹ 20 each at a discount of 10%. The shares were payable as ₹ 4 per share on application, ₹ 8 per share on allotment and the balance on first call. All the money was duly received.
6. (a) Akshay Ltd. made an issue of 20,000 shares of ₹ 10 each payable as follows :

   ₹ 2 on application, ₹ 2 on allotment, ₹ 3 on first call and the balance on second call. The first call is made and all members pay, including a member holding 800 shares, who pays for the balance due in full. Later the final call is made and is fully met.

   Give journal entries.

(b) Nirmal Ltd. with an authorised capital of ₹ 10,00,000, in shares of ₹10 each, issued 50,000 of such shares, payable ₹ 2 per share on application, ₹ 3 on allotment, ₹ 2.50 per share three months later, and duly received. But when the call of ₹ 2.50 was made a shareholder holding 200 share failed to pay the call money while another shareholder holding 400 shares paid the entire Balance. Give journal entries.

7. Goodluck Ltd. issued 50,000 shares of ₹ 10 each at a Premium of ₹4 per share payable as :

On Application ₹ 2 per share

On Allotment ₹ 6 per Share (including Premium ₹ 3)

On first and final Call ₹ 6 per share (including Premium ₹ 1)

Over payment on applications were to be applied towards sums due on allotment only. Applications were received for 75,000 shares. Applicants for 15,000 shares were sent letters of regret and money returned to them in full. Applicants for 15,000 shares were allotted only 5,000 shares. All money due on Allotment and call was duly received.

Make journal entries

8. Super India Petro Chemicals Ltd. was registered with a capital of ₹ 1 crore divided into equity shares of ₹ 100 each. Company purchased plant of ₹ 2500000 and paid the amount by issuing shares at a premium of ₹ 25 per share. Company also issued shares of ₹ 5000000 to the general public at a premium of ₹ 25 per share. The amount payable was:

₹ 65 on application and allotment

₹ 30 on first call and the balance on final call.

Company received applicaitons for 75000 shares Allotment was made as follows:

Applicants for

10000 shares	nil
40000 shares	Full
25000 shares	10000

Allotment money was received in full but when calls were made all sharesholders paid the amount in full except a shareholder holding 400 shares belonging to the

Notes

category who were allotted full shares. A shareholder holding hundred shares failed to pay the 1st call money which he paid along with the amount of final call Company allows interest on call in advance @6% per annum and charges interest on call-in-arrears @ 12% p.a. After the allotment the calls are made at a interval of 2 months. Make necessary journal entries in the books of the company.

ANSWERS TO INTEXT QUESTIONS

27.1 (i) Denominated (ii) Vendors
(iii) Instalments (iv) Applicants

27.2 (i) Over subscription (ii) Share 1st call
(iii) Called up (iv) Cannot

27.3 (i) gain (ii) ₹ 3
(iii) Securities premium (iv) ₹ 100 per share

27.4 (i) loss (ii) ₹ 90 (iii) ₹ 100 per shares

27.5 (i) Calls in arrears (ii) Calls in advance
(iii) Interest on calls in arrears A/c
(iv) Interest on call in advance A/c

28

FORFEITURE OF SHARES

In the previous lesson you have learnt about the shares and their issue by a Joint Stock Company. You have also learnt that generally the issue price of shares is payable in instalments i.e. on application, on allotment and on calls made from time to time by the Board of Directors of the Company. Sometimes some shareholders fail to pay the called up amount in full i.e., they do not pay on one or more instalments after the allotment of the shares to them. In such a case either the company can go to the court and file a suit against the defaulting shareholders for recovery of the due amount or can cancel the membership of the defaulting shareholders. In case the membership is cancelled, the amount paid by the defaulting members towards share capital stands forfeited. It is called 'Forfeiture of Shares.'

In this lesson you will learn about different situations in which shares can be forfeited and accounting treatment thereof.

OBJECTIVES

After studying this lesson you will be able to:

- explain the meaning of forfeiture of Shares:
- explain the situations in which shares can be forfeited;
- explain accounting treatment for forfeiture of shares issued at par, at discount and at premium and
- prepare relevant accounts.

28.1 MEANING AND PROCEDURE

If a shareholder fails to pay the due amount of allotment or any call on shares issued by the company, the Board of directors may decide to cancel his/her membership of the company. With the cancellation, the defaulting shareholder also loses the amount paid by him/her on such shares. Thus, when a shareholder is deprived of his/her membership due to non payment of calls, it is known as forfeiture of shares. The result of forfeiture of shares is :

> Cancellation of membership of the shareholder.
>
> Reduction of issued share Capital of the company.

Let us take an example to make it more clear. S.K. Ltd. issued 100000 shares of ₹ 10 each payable as ₹ 2 on application, ₹ 2 on allotment, ₹ 3 on first call and ₹ 3 on second and final call. Mr. Harish, the allottee of 100 shares, fails to pay the second and final call money made by the company. In this case if the Board of Directors decide to forfeit his shares, his membership will be cancelled and the amount of ₹ 700 paid by him (on 100 shares ₹ 2 on application, ₹ 2 on allotment and ₹ 3 on first call per share) will be forfeited. Now Mr. Harish will no longer be the member of the company and the issued capital of the company will be reduced by ₹ 1000.

Procedure of forfeiture of shares

The authority to forfeit shares is given to the Board of Directors in Articles of Association of the company. The Board of Directors has to give at least fourteen days notice to the defaulting members calling upon them to pay outstanding amount with or without interest as the case may be before the specified date. The notice must also state that if the shareholders fail to remit the amount mentioned therein within the stipulated period, their shares will be forfeited. If they still fail to pay the amount within the specified period of time, the Board of Directors of the company may decide to forfeit such shares by passing a resolution. The decision regarding the forfeiture of shares should be communicated to the concerned allottees and should be asked to return the allotment letters and share certificates of the forfeited shares to the company.

INTEXT QUESTIONS 28.1

Fill in the blanks with an appropriate word/ words :

(i) If a shareholder fails to pay the due amount on shares, the board of directors may decide to ………………….. shares.

(ii) Forfeiture of shares means

(a) ……………………………………………………………………..

(b) ……………………………………………………………………..

(iii) The authority to forfeit shares is given by company's …………………

(iv) The Board of Directors has to give at least …………….. days notice to the defaulting members.

28.2 ACCOUNTING TREATMENT

You have learnt that shares can be issued at par, at discount and at premium. Accounting treatment for forfeiture of shares in these three situations can be explained as under :

1. Forfeiture of Shares Issued at Par

When shares issued at par are forfeited the accounting treatment will be as follows:

(i) Debit Share Capital Account with amount called up (whether received or not) per share up to the time of forfeiture.

(ii) Credit Share Forfeited A/c. with the amount received up to the time of forfeiture.

(iii) Credit 'Unpaid Calls A/c' with the amount due on forfeited shares. This cancels the effect of debit to such calls which take place when the amount is made due.

The journal entry is :

Share capital A/c Dr.

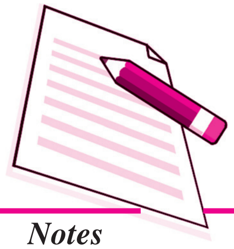
(Amount called up)

To share forfeited A/c

(Amount paid)

To unpaid calls A/c

(Amount called but not paid)



Notes

Note : (i) Amount called up = No. of shares × called up per share

(ii) Amount paid = No. of shares × Amount paid per share

(iii) Amount called but not paid =
No. of shares × Amount called but not paid per share

Illustration 1

X, a shareholder, holding 100 shares of ₹ 10 each has paid application money of ₹ 2 per share and allotment money of ₹ 3 per share, but has failed to pay the first call of ₹ 2 per share and second call of ₹ 3 per share. His shares were forfeited. Make the journal entry to record the forfeiture of shares.

Solution :

Journal Entry

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c (100 × ₹ 10) Dr.		1,000	
	To Share forfeited A/c (100 × ₹ 5)			500
	To Share First Call A/c (100 × ₹ 2)			200
	To Share Second and Final Call A/c (100 × ₹ 3)			300
	(forfeiture of 100 shares)			

Illustration 2

Alpha Ltd. issued 10000 shares of ₹ 100 each payable as :

₹ 25 on application.

₹ 25 on allotment

₹ 20 on First call and

₹ 30 on second and final call.

9000 shares were applied for and allotted. All the payments were received with the exception of allotment money, first call and second and final call money on 300 shares allotted to Ganesh. The Board of Directors decided to forfeit these shares. Make journal entry to record transaction relating to forfeiture of shares.

Solution :

Journal Entry

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c (300 × ₹ 100) Dr.		30,000	
	To Share forfeited A/c (300 × ₹ 25)			7,500
	To Share allotment A/c (300 × ₹ 25)			7,500
	To Share first call A/c (300 × ₹ 20)			6,000
	To Share second call A/c (300 × ₹ 30)			9,000
	(300 shares of ₹ 100 each forfeited due to non payment of allotment money and calls money)			

Forfeiture of Shares Allotted on Pro-rata Basis

In case the shares being over subscribed one of the scheme of allotment of shares to applicants is to allot in the ratio of shares for which applications are entertained by the company for allotment and the number of shares company has offered for subscription. This is called allotment of shares on pro-rata basis. In case of pro-rata allotment the excess money received on applications is transferred to Share Allotment A/c from Share Application A/c. In case a shareholder fails to make payment on allotment and call money of shares held by him/her, the unpaid amount will be calculated as under:

(i) Number of shares applied for allotment

$$= \frac{\text{Total No. of Shares Applied} \times \text{Shares Alloted to Defaulter}}{\text{Total Share Allotted}}$$

(ii) Excess Applications Received =

Number of shares applied for (as per step) – number of shares allotted

(iii) Excess application money received = Excess number of applied shares × money called per share on application.

(iv) Amount unpaid on allotment = Amount due on allotment – Excess application money adjusted towards allotment

Illustration 3

A company has offered for subscription to the public 10000 shares of ₹ 10 each. It has received applications for 15000 shares. Company has decided to allot shares

Notes

on prorata basis. Gunakshi holding 200 shares failed to pay allotment money and first call money. Her shares were forfeited :

Amount payable was as under :

₹ 2 per share on application.
₹ 3 per share on allotment.
₹ 5 per share on call.

Make journal entries and prepare relevant account in the books of the company.

Solution :

Working Notes

Number of Shares Applied by Gunakshi $= \frac{15,000}{10,000} \times 200$

$= 300$

Excess Applications Received $= 300 - 200 = 100$

Excess Applications Amount Received $= 100 \times 2 =$ ₹ 200

Amount Due on Allotment $= 200 \times 3 =$ ₹ 600

Excess Application Money Adjusted = ₹ 200

Net Unpaid Amount on Allotment = ₹ 600 – ₹ 200 = ₹ 400

Journal Entries

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr. To Share Application A/c (Share application money received for 15000 shares @ ₹ 2 per share)		30,000	 30,000
2.	Share Application A/c Dr. To Share capital A/c To Share Allotment A/c. (Share application money for 10000 shares transferred to share capital A/c on their allotment and application money for 500 shares transferred to share allotment A/c.)		30,000	 20,000 10,000

3.	Share Allotment A/c Dr To Share Capital A/c (Allotment money due on 10000 Shares @ ₹ 3 per share)		30,000	30,000
4.	Bank A/c Dr To Share Allotment A/c (Allotment money received on 9800 shares)		19,600	19,600
5.	Share First & Final call A/c Dr To Share Capital A/c. (Call money made due on 10000 Shares @ ₹ 5 per share)		50,000	50,000
6	Bank A/c Dr To Share First & Final Call A/c (Call Money received on 9800 shares @ ₹ 5 per share)		49,000	49,000
7.	Share capital A/c Dr To Share forfeited A/c To Share Allotment A/c To Share First & Final call A/c (200 shares forfeited for non payment of allotment & call money)		2,000	 600 400 1,000

Working Note

$$\frac{15,000}{10,000} \times 200 = 300 \text{ Shares were applied.}$$

300 x 2	=	₹ 600
200 x 2	=	- ₹ 400
Advance	=	₹ 200

Adjusted on Allotment

Total Requirement	₹ 30,000
(-) Advance	₹ 10,000
	₹ 20,000
(-) Arrear	₹ 400
	₹ 19,600

(200 x 3 = 600 - 200 adv) = ₹ 400

Notes

Ledger

Bank A/c

Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Share Application A/c		30,000		Balance c/d		98,600
	Share Allotment A/c		19,600				
	Share First and Final call A/c		49,000				
			98,600				98,600
	Balance b/d		98,600				

Share Applicaiton A/c

Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Share Capital A/c		20,000		Bank A/c		30,000
	Share Allotment A/c		10,000				
			30,000				30,000

Share Capital A/c

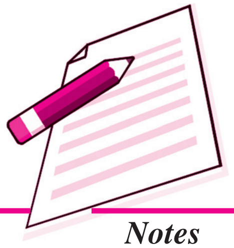
Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Share Forfeited A/c		600		Share Application A/c		20,000
	Share Allotment A/c		400		Share Allotment A/c		30,000
	Share First and Final call A/c		1,000		Share First and Final call A/c		50,000
	Balance cld		98,000				
			1,00,000				1,00,000
					Balance b/d		98,000

Share Allotment A/c

Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
	Share Capital A/c		30,000		Bank A/c		19,600
					Share Application Ac		10,000
					Share Capital A/c		400
			30,000				30,000



Share First and Final Call A/c

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		50,000		Bank A/c		49,000
					Share Capital A/c		1,000
			50,000				50,000

Share Forfeited A/c

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Balance cld		600		Share Capital A/c		600
			600				600
					Balance b/d		600

Balance Sheet of .... Co. Ltd.
As at ....

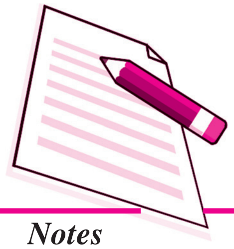
Particulars	*Note No.*	₹
I. Equity and Liabilities		
1. Shareholders' Funds		
(a) Share Capital	1	98,600

Note 1 :

Share Capital

Authorised Capital

.... Equity Share of ₹ 10 each	....
Issued Capital	
10,000 Equity Shares of ₹ 10 each	1,00,000
Subscribed	
Subscribed & Fully Paid up	
9,800 Equity shares of ₹ 10 each	98,000
Add : Share Forfeiture A/c	600
	98,600



Notes

INTEXT QUESTIONS 28.2

i. 200 shares of ₹ 100 each were forfeited for non payment of first call of ₹20 per share and find call of ₹30 per share. Write the amount against each account in the journal entry for forfeiture of shares :

		₹	₹
Share Capital A/c	Dr.	(a)	
To Share Forfeited A/c			(b) ....
To Share First Call A/c			(b) ....
To Share Final Call A/c			(d) ....
(Forfeitures of 200 shares of ₹ 100 each for non payment of first call and final call)			

ii. A Joint Stock Company has offered for subscription 50000 shares of ₹ 100 each on which it has demanded ₹ 30 on application, ₹ 40 on allotment and balance as and when required. Applications were received for 60000 shares. Allotment to the applicants was made on prorata basis. Rakesh who was allotted 200 shares did not pay the allotment money. Ascertain the following amounts of Rakesh's shares.

(a) Excess application amount received ₹ ....

(b) Amount due on allotment ₹ ....

(c) Net unpaid amount on allotment ₹ ....

28.3 FORFEITURE OF SHARES ISSUED AT PREMIUM AND AT DISCOUNT

Forfeiture of Shares Issued at Premium

In case shares are issued at premium and thereafter forfeited there can be two situations :

- Premium on shares has been received prior to the forfeiture.
- Amount of premium on shares has not been received and it still stands credited to the Securities Premium A/c.

1. **Premium Money has been Received Prior to the Forfeiture :** If the amount

of premium on shares forfeited has been received by the company prior to the forfeiture, securities Premium A/c will not get affected. In this case the journal entry of forfeiture of shares will be similar to the entry made as if the shares had been issued at par.

The journal entry will be :

Share Capital A/c Dr.
    To Share forfeited A/c
    To Unpaid Calls A/c./Calls in arrears A/c
(forfeiture of share issued at premium)

Illustration 4

M.B. Software Ltd. issued ₹ 500000 capital divided into equity shares of ₹ 10 each. The shares were issued at a premium of ₹ 4 per share and were payable as : ₹ 3 per share on application, ₹ 7 (including premium) per share on allotment and the balance on call.

All the shares applied for and were duly allotted. All the money was duly received except on 500 shares on which the call money was not received. Company decided to forfeit these shares. Make journal entry to record the forfeiture of 500 shares.

Solution :

Journal Entry

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c Dr.		5,000	
	To Share Forfeited A/c			3,000
	To Share First & Final Call A/c			2,000
	(Forfeiture of 500 shares of ₹ 10 each due to on non payment of call money of ₹ 4 per share)			

2. **Premium on shares has not been received and stands credited to Securities Premium A/c as due but not paid :** When a share is forfeited on which the amount of premium has been made due but has not been received, either wholly or partially, the Securities Premium A/c will be cancelled. At the time of making due, Securities Premium A/c will be credited. The journal entry will be as follows:

Notes

Share Capital A/c Dr
Securities Premium A/c Dr
    To Share Forfeited A/c
    To Unpaid call A/c.
(Forfeiture of shares originally issued at premium due to non payment of dues)

Illustration 5

The Latest Technology Company Ltd. offered to public for subscription of 50,000 shares of ₹ 20 each at a premium of ₹ 5 per share. The amount was payable as under :

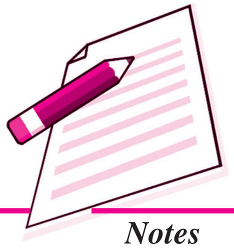
On application	₹ 5 per share
On allotment	₹ 12 per share (Including premium of ₹ 5 per share)
On first call	₹ 4 per share
On Second and Final call	₹ 4 per share

Applications were received for all the shares. Allotment was made to all the applicants in full. Ashima failed to pay allotment and call money on 200 shares held by her. Reshma was allotted 300 shares. She did not pay the call money. Their shares were forfeited. Make necessary journal entry for the forfeiture only.

Solution :

Journal Entries

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
(i)	Share Capital A/c (₹200 × 20) Dr.		4,000	
	Securities Premium A/c (₹200 × 5) Dr.		1,000	
	To Share Forfeited A/c (₹200 × 5)			1,000
	To Share Allotment A/c (₹200 × 12)			2,400
	To Share First Call A/c (₹200 × 4)			800
	To Share Second and Final call A/c (₹200 × 4)			800
	(Forfeiture of 200 shares held by Ashima who did not pay allotment and call money)			



(ii)	Share Capital A/c (₹300 × 20) Dr.		6,000	
	To Shares forfeited A/c ₹(300 × 12)			3,600
	To Share First Call A/c (₹300 × 4)			1,200
	To Share Second Call A/c (₹300 × 4)		1,200	
	(Forfeiture of 300 shares held by Reshma)			

Combined entry of the above will be as :

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c Dr.		10,000	
	Securities premium A/c Dr.		1,000	
	To Share forfeited A/c			4,600
	To Share Allotment A/c			2,400
	To Share First Call A/c			2,000
	To Share Second and Final Call A/c			2,000
	(Forfeiture of 200 shares held by Ashima, who did not pay allotment and call and 300 share of Reshma who did not pay call money)			

Forfeiture of Shares Issued at Discount

Discount on issue of shares is a loss to the company. When shares issued at a discount are forfeited for non payment of dues, the discount allowed on such shares is written back. At the time of issue of shares, Discount on issue of Shares A/c is debited and when forfeited, this account is credited to cancel the discount allowed on such shares. In this case the following journal entry is made :

Share Capital A/c Dr.

To Share Forfeited A/c

To Discount on Issue of Shares A/c

To Unpaid call A/c

(Forfeiture of shares originally issued at discount for non payment of dues).

Illustration 6

The Evergrowing Ltd. invited applications for 20000 shares of ₹ 50 each at a discount of 10% payable as follows:

On application	₹ 10 per share
On allotment	₹ 20 per share
On call	₹ 15 per share

Notes

Whole of the issue was subscribed and paid for except the calls money on 200 shares which were forfeited by the company.

Make journal entry for forfeiture of shares.

Solution :

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c (₹200 × 50) Dr.		10,000	
	To Share forfeited A/c (₹200 × 30)			6,000
	To Discount on Issue of Shares A/c (₹200 × 5)			1,000
	To Share First and Final call A/c (₹200 × 15)			3,000
	(Forfeiture of 200 shares of ₹ 50 each issued at discount of 10% on non payment of call money)			

Illustration 7

M/s Herbal Tea Plantations Ltd. was registered with a capital of ₹ 1 crore divided into equity shares of ₹ 100 each. The company offered to public 50000 shares at a premium of ₹ 20 per share. The amount on shares was payable as :

₹ 25 on application
₹ 50 (including ₹ 20 premium) on allotment
₹ 20 on first call and
₹ 25 on final call.

Applications were received for 75000 shares. Shares were alloted to the applicants on prorata basis. Kanti Bhai who was allotted 500 shares did not pay the allotment money. He also failed to pay the first call. His shares were forfeited. Sheetal was holding 200 shares did not pay the first call. Final call was not made.

Make journal entries in the books of the company.

Solution :

M/s Herbal Tea Plantations Ltd
Journal Entries

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr.		18,75,000	
	To Share Application A/c			18,75,000
	(Application money received)			

2.	Share Application A/c Dr.		18,75,000	
	To Equity Share Capital A/c			12,50,000
	To Share Allotment A/c			6,25,000
	(Application money of 50000 share transferred to share Capital A/c on their allotment and remaining adjusted towards shares allotment)			
3.	Share Allotment A/c Dr.		25,00,000	
	To Equity Share Capital A/c			15,00,000
	To Securities Premium A/c			10,00,000
	(Allotment money due including premium)			
4.	Bank A/c Dr.		18,56,250	
	To Share Allotment A/c			18,56,250
	(Allotment money received)			
5.	Share First Call A/c Dr.		10,00,000	
	To Equity Share Capital A/c			10,00,000
	(First call money due)			
6.	Bank A/c Dr.		9,86,000	
	Call-in-arrears A/c Dr.		4000	
	To Share First Call A/c			9,90,000
	(First call money received of 49300 shares of 200 share debited to calls-in-arrears A/c)			
7.	Share Capital A/c Dr.		37,500	
	Securities Premium A/c Dr.		10,000	
	To Share Forfeited A/c			18,750
	To Share Allotment A/c			18,750
	To share First Call A/c			10,000
	(Forfeiture of 500 shares on non payment of allotment and call money)			

Working Notes :

Shares applied for 75,000

Share Allotted 50000

Ratio = 3 : 2

Number of shares holded by Kanti Bhai = 500

Number of shares applied $500 \times \frac{3}{2}$ = 750

Excess application money received = 250 × 25 = ₹ 6250

Share allotment money due = 500 × ₹s 50 = ₹ 25000

Net Amount due after adjustment of excess applicaiton money

= ₹ 25000 – ₹ 6250 = ₹ 18750

Total allotment money due = ₹ 2500000

Less excess application money adjusted ₹ 625000

Less Kanti Bhai's amount due on allotment ₹ 18750

Net Amount Received ₹ 1856250

INTEXT QUESTIONS 28.3

In the following cases write whether the account given is to be debited or credited and the amount by which it is debited or credited.

(i) Forfeiture of 100 shares of ₹ 10 each fully paid issued at par on which final call of ₹ 3 per share is not received.

Shares forfeited A/c.

(ii) 250 shares of ₹ 10 each issued at a premium of ₹ 4 per share forfeited for non payment of call money, of ₹ 2 per share premium as called with allotment is paid.

Shares forfeited A/c

(iii) 100 shares of ₹ 10 each issued as fully paid at a premium of ₹ 2 per share forfeited on which only application money @ ₹ 2 per share is received.

Securities Premium A/c

(iv) 200 shares of ₹ 20 each issued at a discount of ₹ 2, ₹ 15 called are forfeited for non payment of final call of ₹ 5 per share.

Discount on issue of shares A/c

WHAT YOU HAVE LEARNT

- Forfeiture of shares means cancellation of membership of a shareholder due to non payment of calls made by the company. Forfeiture of shares amount to
  - Cancellation of the membership of the defaulting shareholder and
  - Reduction of share capital of the company.
- Power to forfeit shares is given in the Articles of Association of the company. The Board of Directors have to give a fourteen days notice to the defaulting shareholder
- There are three situations when shares can be forfeited:

  (i) Shares issued at par

  (ii) Shares issued at premium

  (a) Premium received in full

  (b) Premium due but not yet received

  (iii) Shares issued at discount
- In all cases share capital is debited by the called up amount on forfeited shares
- Shares forfeited A/c is credited by the amount received (excluding the amount of premium) on forfeited shares.
- Securities premium A/c will not get affected if premium on forfeited shares has been received but it will be debited if it is due but not received.
- Shares issued at a discount when forfeited discount on issue of shares will always be credited by the amount of discount allowed on forfeited shares:

TERMINAL EXERCISE

1. State the meaning of forfeiture of shares. When can shares be forfeited?
2. What accounting treatment is given to Securities Premium A/c on forfeiture of shares when:

   (i) Amount of premium has been received

   (ii) Amount of premium has not been received on such forfeited shares.

Notes

3. X Ltd. forfeited 500 shares of ₹ 100 each on which final call of ₹ 30 per share has not been received. Other calls have been duly received. Make journal entry to record the forfeiture of shares.

5. All Time Entertainment Ltd. issued 50000 shares of ₹ 10 each at a premium of ₹ 4 per share payable as ₹. 3 per share on application ₹ 7 (including premium) on allotment and the balance on call. Akbar who was allotted 300 shares failed to pay the allotment amount and on his subsequent failure to pay the call money his shares were forfeited. Make the journal entry for the forfeiture of 300 shares.

6. Exe Ltd issued 10000 shares of ₹ 50 each at a discount of ₹ 5 per share payable as ₹10 per share on application, ₹ 20 per share on allotment and the balance on call. All money was duly received except of 400 shares on which allotment and call money was not received. These shares were forfeited. Make journal entries in the books of the company and prepare ledger accounts also.

7. The Multi Media Ltd. invited applications for issuing 50000 shares of ₹ 100 each at a premium of ₹ 20 per share. The amount was payable as follows:

On Application	₹ 30 per share
On Allotment	₹ 60 per share (including premium)
On First and Final call	₹ 30 per share

Applications were received for 1 lakh shares. Applications for 20000 shares were totally rejected and money was returned. Remaining applicants were allotted on prorata basis. Sukhbhinder who was allotted 400 shares did not pay the allotment money. On his subsequent failure to pay the call money, his shares were forfeited. Rajender who had applied for 400 shares failed to pay the call money. His shares were also forfeited after final call. Make journal entries in the books of the company and prepare necessary ledger accounts.

8. Aggarwal constructions Ltd. offered to public for subscription 40000 shares of ₹ 50 each at a premium of ₹ 10 per share. The amount of these shares is payable as :

₹ 20 per share on application

₹ 30 per share on allotment (including ₹ 10 of premium)

and the balance of First and Final call

Applications were received for 75000 shares. Applicants of 15000 were sent letters of regret and their application money was returned. Remaining applicants were allotted shares on prorata basis. Sudhir holding 400 shares did not pay the allotment money. His shares were forfeited and call was made. Make journal entries.

Notes

ANSWERS TO INTEXT QUESTIONS

28.1
- (i) forfeit
- (ii) (a) cancellation of membership of the company
  (b) reduction of issued capital
- (iii) Articles of Association
- (iv) Fourteen

28.2
- i. (a) ₹ 20000 (b) ₹ 10000 (c) ₹ 4000 (d) ₹ 6000
- ii. (a) 40 × 30 = ₹ 120 (b) 200 × 40 = ₹ 800
  (c) ₹ 800 – ₹ 120 = ₹ 680

28.3
- (i) Credited by ₹ 700 (ii) Credited by ₹ 2000
- (iii) Debited by ₹ 200 (iv) Credited by ₹ 400

29

REISSUE OF FORFEITED SHARES

You have learnt that a company may call share money in instalments. You have also learnt that if a shareholder fails to pay the allotment and/or call money, the company may forfeit such shares. If shares are forfeited the membership of the shareholder stands cancelled and the shares become the property of the company. Thereafter, the company has an option of selling such forfeited shares. The sale of forfeited shares is called 'reissue of shares'.

In this lesson you will learn the meaning of 'reissue of shares' and its accounting treatment in the books of the company.

OBJECTIVES

After studying this lesson you will be able to:

- state the meaning of reissue of shares;
- state the minimum price at which a company can reissue its forfeited shares and
- give accounting treatment of reissue of shares in different situations.

29.1 REISSUE OF SHARES : MEANING AND ISSUE PRICE

Shares are forfeited because only a part of the due amount of such shares is received and the balance remains unpaid. On forfeiture the membership of the original allottee is cancelled. He/she cannot be asked to make payment of the remaining amount. Such shares become the property of the company. Therefore company may sell these shares. Such sale of shares is called 'reissue of shares'. Thus reissue of shares means issue of forfeited shares.

Reissue of Forfeiture Shares

Once the Board of directors has forfeited the shares, the defaulting share holder is asked to return the share certificate which is cancelled thereafter. The board of directors passes a resolution allotting the forfeited shares to the new purchaser/ purchasers of such shares.

In case of reissue of shares neither a prospectus is issued nor any offer is otherwise made to the general public. Though the amount of such shares may be called in more than one instalment but usually the entire amount is called in one instalment i.e. lumpsum.

The board of directors of the company while reissuing the shares decide the price of reissue. These shares can be reissued at par, at premium or at discount. Generally, these shares are reissued at a discount i.e. at a price which is less than its nominal value. The amount of discount allowed at the time of reissue in no case should be more than the amount forfeited on such shares.

Question arises at what price the forfeited shares can be reissued? There is no limit of the price at which it can be reissued if price charged is more than the price of issue at the time of their forfeiture. But then there is a limit below which price cannot be charged or we can say that there is a minimum price below which the company cannot reissue its forfeited shares. We can look at it from another angle i.e. the company cannot give discount more than a particular amount while reissuing the forfeited shares.

The maximum permissible discount at the time of reissue of forfeited shares is ascertained in different situations in the following manner:

(i) **Shares Originally Issued at Par :** When the shares are originally issued at par, the maximum permissible discount for reissue of shares is equal to the amount forfeited on such shares

(ii) **Shares Originally Issued at Premium :** In case of shares originally issued at premium, there can be two situations : (a) premium has not been received on the forfeited shares, and (b) premium has been received on such shares. The amount forfeited is the amount that has been received including the amount of premium if it has been received and the maximum discount that can be allowed on reissue of such shares is the amount so forfeited.

(iii) **Shares Originally Issued at Discount :** In this case the actual amount received becomes the forfeited amount. But the maximum permissible discount on reissue of shares will be equal to the amount forfeited plus the amount of discount initially allowed on these shares at the time of their original issue.

Notes

INTEXT QUESTIONS 29.1

Fill in the blanks with suitable word/words :

(i) On forfeiture of shares the membership of the .... allottee is cancelled.

(ii) Forfeited shares are the property of the ....

(iii) When the shares are originally issued at par, the maximum permissible discount for reissue of shares is equal to the amount .... on such shares.

(iv) In case shares are originally issued at premium the amount forfeited is the amount that has been received including the amount of .... that has been received.

(v) On reissue of forfeited shares which were originally issued at discount, the permissible discount will be the amount forfeited plus the amount of .... originally allowed.

29.2 RECORDING OF REISSUE OF SHARES

Reissue of Forfeited Shares at a Discount

When the shares forfeited are reissued at discount, Bank account is debited by the amount received and Share capital account is credited by the paid up amount. The amount of discount allowed is debited to Share Forfeited Account. This is for adjusting the amount of discount so allowed from the amount forfeited at the time of forfeiture.

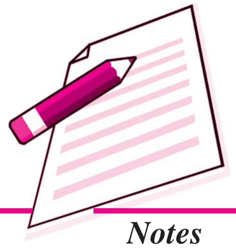
The journal entry for the above will be as follows:

Bank A/c (the amount received on reissue)	Dr.
Share Forfeited A/c (the amount allowed as discount)	Dr.
To Share Capital A/c (paid up amount)	

As stated earlier the amount of discount allowed on reissue of shares at the most can be equal to the forfeited amount on such shares. In that case the share forfeited account after reissue will show a zero balance. But in case, this amount of discount is less than the amount forfeited, the remaining forfeited amount will be profit for the company. This profit is a capital gain to the company and is transferred to Capital Reserve account. Journal entry of the same will be as follows :

Share Forfeited A/c	Dr
To Capital Reserve A/c	

(Transfer of surplus share forfeited amount to capital reserve A/c)



If all the forfeited shares are reissued, the Share Forfeited A/c will show a zero balance because whole of the amount of this account after adjusting the amount of discount allowed on reissue will be transferred to capital reserve account. But in case, only a part of the forfeited shares are reissued and others remain cancelled, the amount forfeited on forfeited shares not reissued will remain in the Shares Forfeited Account. For adjustment of forfeited amount on share reissued will be calculated as :

Amount to be Adjusted =

$$\frac{\text{Total Forfeited Amount}}{\text{Total No. of Shares Forfeited}} \times \text{Number of Shares Reissued}$$

INTEXT QUESTIONS 29.2

Given below are certain statements. Write (C) against the correct statements and (I) against the incorrect statements:

(i) Share forfeited account can show a zero balance.

(ii) Discount allowed on reissue of forfeited shares will be debited to discount on issue of shares account.

(iii) Balance amount of share forfeited account after adjusting discount allowed on reissue of these share remains in the same account

29.3 ACCOUNTING TREATMENT OF REISSUE OF FORFEITED SHARES

There can be four situations of reissue of forfeited shares. These are:

(i) Reissue of forfeited shares at discount originally issued at par

(ii) Reissue of shares at par or at premium, originally issued at par

(iii) Reissue of forfeited shares at par, at discount and at premium originally issued at premium.

(iv) Reissue of forfeited shares at par, at discount and at premium, originally issued at discount.

Accounting treatment in each of the above cases is discussed hereafter :

1. Reissue of forfeited shares issued at discount, originally issued at par

In this case the maximum discount that can be given on reissue of forfeited shares is the amount that has been received on these shares and is debited to share forfeited account.

Notes

Illustration 1

X company Ltd. forfeited 200 shares of ₹ 10 each, fully called up on which ₹ 7 have been received and final call of ₹ 3 per share remains unpaid. These shares were later on reissued for ₹ 8 per share fully paid up. Make journal entry for recording the forfeiture and reissue of shares.

Solution

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	Share Capital A/c	Dr.		2,000	
	To Share Forfeited A/c				1,400
	To Share Final call A/c				600
	(Forfeiture of 200 shares of ₹ 10 each due to non payment of final call of ₹ 3 per share)				
(ii)	Bank A/c	Dr.		1,600	
	Share Forfeited A/c	Dr.		400	
	To Share capital A/c				2,000
	(Reissue of 200 forfeited shares of ₹ 10 each for ₹ 8 per share as fully paid up)				
(iii)	Share forfeited A/c	Dr.		1,000	
	To Capital Reserve A/c				1000
	(The Balance amount in Share Forfeited A/c transferred to Capital Reserve A/c)				

2. Reissue of forfeited shares at premium and at par, originally issued at par

In this case the whole of the amount that has been credited to Shares Forfeited A/c is transferred to Capital Reserve A/c on the reissue of such shares.

Illustration 2

Y Ltd. forfeited 400 shares of ₹ 20 each, on which ₹ 15 per share have been received and balance remains due but not paid. These shares were reissued

(a) at the rate of ₹ 20 per share i.e. at par

(b) at the rate of ₹ 24 per share i.e. at premium

Make necessary journal entries for reissue of the shares

Solution :

Journal Entries

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
Case (a)				
(i)	Bank A/c Dr.		8,000	
	To Share Capital A/c			8,000
	(Reissue of 400 share at the rate of ₹ 20 per share)			
(ii)	Shares Forfeited A/c Dr.		6,000	
	To Capital Reserve A/c			6,000
	(Balance amount of Share Forfeited A/c is transferred to Capital Reserve A/c)			
Case (b)				
(i)	Bank A/c Dr.		9,600	
	To Share Capital A/c			8,000
	To Securities Premium Reserve A/c			1,600
	(Reissue of forfeited shares at premium)			
(ii)	Share Forfeited A/c Dr.		6,000	
	To Capital Reserve A/c			6,000
	(Balance amount of Shares Forfeited A/c is transferred to Capital Reserve A/c)			

In the above two illustrated cases, total amount forfeited on shares reissued is transferred to capital reserve because no discount has been given on reissue of these shares. Therefore, the whole of the amount forfeited is a gain for the company.

3. Reissue of forfeited shares at par, at discount and at premium, originally issued at premium :

If the shares were originally issued at premium, it is not necessary that their reissue after forfeiture is to be at premium. Such shares can be reissued at par, at discount or at premium.

If such shares are reissued at premium the premium received should be credited to Securities Premium A/c. Journal entry will be

Notes

Bank A/c Dr.
(Number of shares × amount received per share)
To Share Capital A/c
(Number of shares × amount paid up per share)
To Securities Premium Reserve A/c
(Number of shares × amount of premium per share)

If such shares are reissued at par the amount that has been received and has been credited to share forfeited A/c will be credited to capital reserve A/c

If such shares are reissued at discount, the amount of discount allowed will be adjusted towards the amount credited to share forfeited A/c the balance amount of Share Forfeited A/c will be transferred to Capital Reserve A/c

Illustration 3

AZ Ltd. forfeited 200 shares of ₹ 10 each originally issued at a premium of ₹4 per share, the holder of which paid ₹ 3 per share on application but did not pay the allotment money of ₹ 7 per share (including premium) and call of ₹ 4 per share. Make necessary journal entries for the forfeiture and for reissue of these shares if :

I. Reissued at ₹ 10 per share i.e. at par
II. Reissued at ₹ 8 per share i.e. at discount
III. Reissued at ₹ 12 per share i.e. at premium

Solution :

Journal Entries

	Particulars	*L.F.*	*Dr.* ₹	*Cr.* ₹
(i)	Share Capital A/c (200 × ₹ 10) Dr.		2,000	
	Securities Premium Reserve A/c (200 × ₹ 4) Dr.		800	
	To Share Forfeited A/c (200 × ₹ 3)			600
	To Share Allotment A/c (200 × ₹ 7)			1,400
	To Share First & Final Call A/c (200 × ₹ 4)			800
	(Forfeiture of 200 shares for non-payment of dues)			

Reissue of Forfeiture Shares

Case I

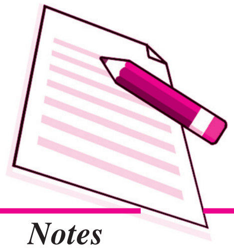
	Particulars		*L.F.*	*Dr.* ₹	*Cr.* ₹
(i)	Bank A/c	Dr.		2,000	
	To Share Capital A/c				2,000
	(Reissue of 200 forfeited shares reissued at par)				
(ii)	Share Forfeited A/c	Dr.		600	
	To Capital Reserve A/c				600
	(Share Forfeited A/c balance is transferred to Capital Reserve A/c)				

As the forfeited shares have been reissued at par therefore no discount is allowed on these shares at the time of their reissue. Therefore the full forfeited amount of ₹ 600 is a gain for the caompany which is transferred to Capital Reserve A/c

Case II

	Particulars		*L.F.*	*Dr.* ₹	*Cr.* ₹
(i)	Bank A/c	Dr.		1,600	
	Share Forfeited A/c	Dr.		400	
	To Share Capital				2,000
	(Reissue of 200 forfeited shares reissued at discount)				
(ii)	Share Forfeited A/c	Dr.		200	
	To Capital Reserve A/c				200
	(Balance amount of Shares Forfeited A/c is transferred to Capital Reserve A/c)				

At the time of reissue of forfeited shares a discount of ₹ 2 per share is allowed so the total amount of discount of ₹ 400 is adjusted from the forfeited amount of ₹ 600 and the balance amount of ₹ 200 is transferred to Capital Reserve A/c being a capital gain.



Notes

Case III

	Particulars	*L.F.*	*Dr.* ₹	*Cr.* ₹
(i)	Bank A/c Dr.		2,400	
	To Share Capital A/c			2,000
	To Securities Premium Reserve A/c			400
	(200 forfeited shares reissued at premium)			
(ii)	Share Forfeited A/c Dr.		600	
	To Capital Reserve A/c			600
	(Balance amout of Share Forfeited A/c transferred to Capital Reserve)			

As the forfeited shares have been issued at a premium so no amount of discount is there to be adjusted from the forfeited amount hence the total forfeited amount of ₹ 600 is transferred to capital Reserve A/c as capital gain of the company.

4. Reissue of forfeited shares at par, premium and discount, originally issued at discount

When the forfeited shares originally issued at discount are reissued, the discount allowed at the time of original issue of such shares which was written back at the time of their forfeiture is again allowed. Thus on forfeiture shares Discount A/c is credited by the amount of discount allowed at the time of issue because its effect is to be cancelled out when shares were forfeited. When the same shares are reissued, discount on issue of shares A/c is again debited by the original amount of discount.

Illustration 4

India infrastructure Ltd. has issued its shares of ₹ 20 each at a discount of ₹2 per share. Mahima holding 100 shares did not pay final call of ₹ 5 per share. Her shares were forfeited. Later on the company reissued these forfeited shares at (I) ₹ 15 per share (II) ₹ 20 per share, and (III) ₹ 25 per share

Make journal entries for the forfeiture and reissue of the shares in the books of company.

Solution :

Journal Entries

	Particulars		*L.F.*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c	Dr.		2,000	
	To Share Forfeited A/c				1,300
	To Discount on Issue of Shares A/c				200
	To Share Final Call A/c				500
	(Forfeiture of 100 shares issued at discount for non payment of final call)				

Reissue of shares: Reissued at ₹ 15 per share

	Particulars		*L.F.*	*Dr.* ₹	*Cr.* ₹
I.	(i) Bank A/c	Dr.		1500	
	Discount on Issue of Shares A/c	Dr.		200	
	Share Forfeited A/c	Dr.		300	
	To Share Capital A/c				2,000
	(100 shares reissued at ₹ 15 per share)				
	(ii) Share Forfeited A/c	Dr.		1,000	
	To Capital Reserve A/c				1,000
	(Balance in share Forfeited A/c of 100 shares reissued transferred to Capital Reserve A/c)				
II.	Bank A/c	Dr.		2,000	
	To Share Capital A/c				2,000
	(100 shares reissued at ₹ 20 per share)				
	Share Forfeited A/c	Dr.		1,300	
	To Capital Reserve A/c				1,300
	(Balance in shares forfeited A/c transferred to Capital Reserve A/c)				

III.	Reissued at ₹ 25 per share			
	Bank A/c Dr.		2,500	
	To Share Capital A/c			2,000
	To Securities Premium Reserve A/c			500
	(Reissue of discounted shares at ₹ 25 per share)			
	Shares Forfeited A/c Dr.		1,300	
	To Capital Reserve			1,300
	(Balance in shares forfeited A/c transferred to capital Reserve A/c)			

Reissue of a Part of the Forfeited Shares

Sometimes all the forfeited shares are not reissued but a part of them are reissued. The accounting treatment is explained by the following illustration.

Illustration 5

A company forfeited 40 shares of ₹ 50 each on which only application money of ₹ 10 per share and ₹ 20 on allotment were received. Final call of the ₹ 20 per share is not received 30 of these shares are reissued at ₹ 40 per share. Make journal entries for forfeiture and Reissue of forfeited shares.

Solution :

Journal Entries

	Particulars	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c Dr.		2,000	
	To Share Forfeited A/c			1,200
	To Share First and Final Call A/c			800
	(40 shares forfeited for non payment of call)			
	Bank A/c Dr.		1,200	
	Share Forfeited A/c Dr.		300	
	To Share Capital A/c			1,500
	(30 of the forfeited shares are reissued)			
	Share forfeited A/c Dr.		600	
	To Capital Reserve A/c			600
	(Balance of forfeited A/c of 30 shares transferred to capital Reserve A/c)			

INTEXT QUESTIONS 29.3

How much amount will be credited to Capital Reserve A/c in the following cases :

(i) 100 shares of ₹ 10 each forfeited for non payment of call of ₹ 3 per share reissued at ₹ 7 per share.

(ii) 200 shares of ₹ 10 each forfeited on which ₹ 8 per share have been called and only ₹ 2 per share have been paid are reissued at ₹ 9 per share fully paid up.

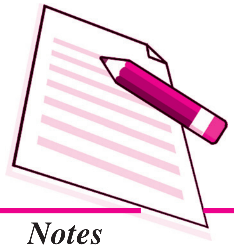
(iii) 100 shares of ₹ 20 each issued at a discount of ₹ 2 per share have been forfeited for non payment of first call of ₹ 4 and final call of ₹5 per share. These shares are reissued at ₹ 15 per share fully paid up.

WHAT YOU HAVE LEARNT

- Reissue of shares means sale of shares which were issued earlier but had been forfeited for non payment of called up amount.
- Shares are reissued to realise at least the amount called but remained unpaid on forfeited shares
- The amount of shares reissued is generally called in one instalment
- Shares can be reissued at par, at discount and at premium
- The maximum permissible discount for reissue of shares is equal to the amount forfeited on these shares
- The forfeited amount is utilised to adjust the amount of discount allowed on reissue of shares
- The balance amount of share forfeited account is a capital gain of the company and is transferred to Capital Reserve A/c

TERMINAL EXERCISE

1. Give the meaning of 'reissue of shares'.
2. What is the maximum permissible discount at the time of reissue of forfeited shares when the forfeited shares originally issued are (a) at par (b) at premium (c) at discount?



Notes

3. What amount is transferred to Capital Reserve A/c after reissue of forfeited shares? Why is this account transferred to capital reserve A/c?

4. Make journal entries for forfeiture and reissue of shares in the following cases:

   (a) The directors of X Ltd. forfeited 400 shares of ₹ 10 each fully called up on which ₹ 2400 have been received. 300 of these shares were reissued upon payment of ₹ 2500

   (b) Real Estate Developers Ltd. forfeited 500 shares of ₹ 10 each held by Amarjeet Singh which were issued at a premium of ₹ 3 per share to be paid along with allotment money. He paid only application money of ₹ 3 per share. 200 of these shares were reissued at ₹ 10 per shares

   (c) Royal Enterprises Ltd. forfeited 200 shares of ₹ 10 each issued at a discount of 10%, on which only ₹ 4 per share have been paid. Out of these 100 shares have been reissued at ₹ 7 per share.

5. Make journal entries

   (a) P Ltd. issued 400 shares of ₹ 10 each to Suresh on which he has paid ₹ 3 per share on application but failed to pay allotment money of ₹3 per share and first call money of ₹ 2 per share. His shares were forfeited before making the fianl call. These shares were later on reissued at ₹ 8 per share fully paid up.

   (b) A company issued 10000 shares of ₹ 100 each at a premium of ₹20 per share, payable as ₹20 on application, ₹ 60 including premium on allotment, ₹ 20 each on two calls. Final call was not made. Pinky holding 200 shares did not pay allotment money and on her non payment of first call, her shares were forfeited by the board of the directors of the company. 150 of these shares were reissued at ₹ 120 per share fully paid up.

6. Joy Entertain Ltd. issued 100000 shares of ₹ 10 each at a premium of ₹2 per share. The amount was payable as :

   ₹ 3 per share on application

   ₹ 5 (including premium) on allotment

   ₹ 2 per share on first call and

   ₹ 2 per share on final call

Application were received for 150000 shares. All applications were accepted and allotment was made on prorata basis Sushil who was allotted 1000 shares failed to pay allotment money. On his subsequent failure of first call his shares were forfeited.

Gomang who had applied for 750 shares failed to pay the two calls. His shares were also forfeited. All the shares of Sushil and 200 shares of Gomang were reissued at a discount of ₹ 2 per share. Make journal entries in the books of the company and open necessary ledger accounts.

7. 21st Century Cotton Mills Ltd was registered with a capital of ₹ 10,00,000 divided into 1 lakh shares of ₹ 10 each. 50000 shares were offered to public for subscription at a discount of ₹ 1 per share. The amount was payable as ₹ 5 per share on application and allotment and ₹ 4 per share on call.

   Applications were received for 48000 shares. Call was made and money was duly received except on 1000 shares. These shares were forfeited.

   800 of forfeited shares were reissued a ₹ 12 per share.

   Make journal entries in the books of the company. Prepare the Balance sheet also.

ANSWERS TO INTEXT QUESTIONS

29.1 (i) original (ii) company (iii) forfeited (iv) premium (v) discount

29.2 (i) C (ii) C (iii) I

29.3 (i) 400 (ii) ₹ 200 (iii) 300

ANSWERS TO TERMINAL EXERCISE

4. (a) Capital Reserve ₹ 1,300 (b) Capital Reserve ₹ 600
   (c) Capital Reserve ₹ 200

5. (a) Capital Reserve ₹ 400 (b) Capital Reserve ₹ 3,000

6. Capital Reserve ₹ 3,300

7. Capital Reserve ₹ 4,000

30

ISSUE OF DEBENTURES

You have learnt that share capital is the main source of finance of a joint stock company. Such capital is raised by issuing shares. Those who hold the shares of the company are called the shareholders and are owners of the company. Company may need additional amount of money for a long period. It cannot issue shares every time. It can raise loan from the public. The amount of loan can be divided into units of small denominations and the company can offer the same for subscription to the public. Each unit is called a 'debenture' and holder of such units is called Debenture holder. The amount so raised is loan for the company. In this lesson we shall learn about issue of debentures and its accounting treatment.

OBJECTIVES

After studying this lesson you will be able to :

- state the meaning and types of debentures;
- explain the procedure of issue of debentures and its accounting treatment;
- explain issue of debentures as collateral security;
- explain 'writing off 'discount' and 'loss' on issue debentures and their accounting treatment in the books of the company and
- calculate interest on debentures.

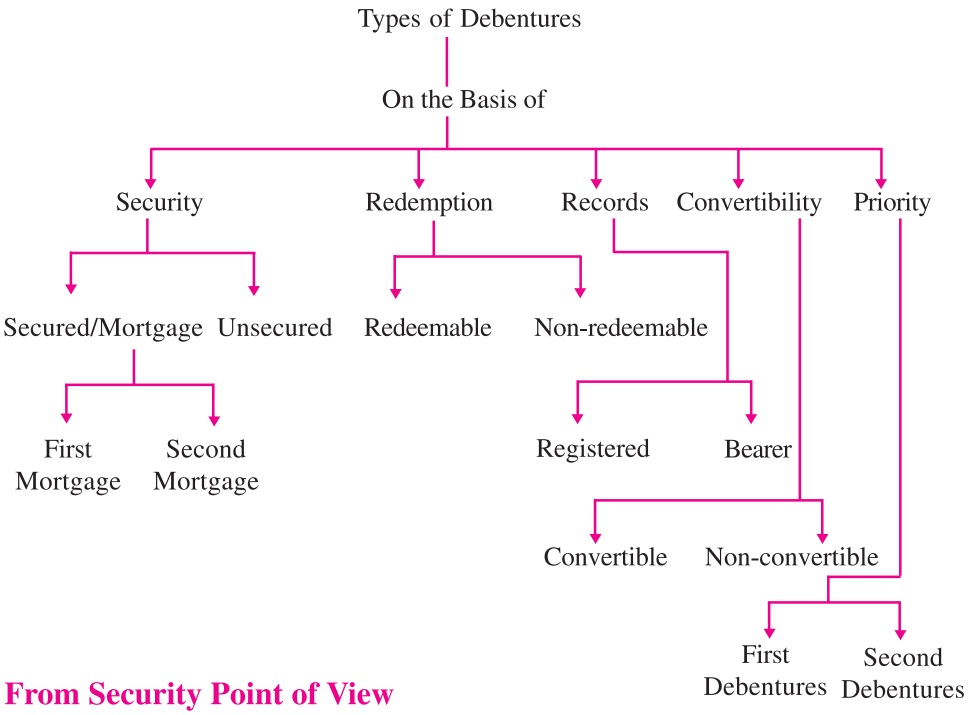
30.1 DEBENTURE AND ITS TYPES

A Debenture is a unit of loan amount. When a company intends to raise the loan amount from the public it issues debentures. A person holding debenture or debentures is called a debenture holder. A debenture is a document issued under the seal of the company. It is an acknowledgment of the loan received by the company equal to the nominal value of the debenture. It bears the date of redemption and rate and mode of payment of interest. A debenture holder is the creditor of the company.

As per section 2(12) of Companies Act 1956, "Debenture includes debenture stock, bond and any other securities of the company whether constituting a charge on the company's assets or not".

Types of Debentures

Debenture can be classified as under :



1. From Security Point of View

(i) **Secured or Mortgage Debentures :** These are the debentures that are secured by a charge on the assets of the company. These are also called mortgage debentures. The holders of secured debentures have the right to recover their principal amount with the unpaid amount of interest on such debentures out of the assets mortgaged by the company. In India, debentures must be secured. Secured debentures can be of two types :

Notes

(a) ***First Mortgage Debentures :*** The holders of such debentures have a first claim on the assets charged.

(b) ***Second Mortgage Debentures :*** The holders of such debentures have a second claim on the assets charged.

(ii) **Unsecured Debentures :** Debentures which do not carry any security with regard to the principal amount or unpaid interest are called unsecured debentures. These are called simple debentures. Such debentures do not have any charge on the assets of the company.

2. On the Basis of Redemption

(i) **Redeemable Debentures :** These are the debentures which are issued for a fixed period. The principal amount of such debentures is paid off to the debenture holders on the expiry of such period. These can be redeemed by annual drawings or by purchasing from the open market.

(ii) **Non-redeemable Debentures :** These are the debentures which are not redeemed in the life time of the company. Such debentures are paid back only when the company goes into liquidation.

3. On the Basis of Records

(i) **Registered Debentures :** These are the debentures that are registered with the company. The amount of such debentures is payable only to those debenture holders whose name appears in the register of the company.

(ii) **Bearer Debentures :** These are the debentures which are not recorded in a register of the company. Such debentures are transferrable merely by delivery. Holder of these debentures is entitled to get the interest.

4. On the Basis of Convertibility

(i) **Convertible Debentures :** These are the debentures that can be converted into shares of the company on the expiry of predecided period. The term and conditions of conversion are generally announced at the time of issue of debentures.

(ii) **Non-convertible Debentures :** The debenture holders of such debentures cannot convert their debentures into shares of the company.

5. On the Basis of Priority

(i) **First Debentures :** These debentures are redeemed before other debentures.

(ii) **Second Debentures :** These debentures are redeemed after the redemption of first debentures.

INTEXT QUESTIONS 30.1

Name the type of debentures against each of the following :

(i) Debentures that are redeemed before other debentures.

(ii) Debentures the holders of which have a first claim on the assets charged.

(iii) Debentures that are transferable merely by delivery.

(iv) Debentures that are paid back only when the company goes into liquidation.

30.2 ISSUE OF DEBENTURES

By issuing debentures means issue of a certificate by the company under its seal which is an acknowledgment of debt taken by the company.

The procedure of issue of debentures by a company is similar to that of the issue of shares. A Prospectus is issued, applications are invited, and letters of allotment are issued. On rejection of applications, application money is refunded. In case of partial allotment, excess application money may be adjusted towards subsequent calls.

Issue of Debenture takes various forms which are as under :

1. Debentures issued for cash
2. Debentures issued for consideration other than cash
3. Debentures issued as collateral security.

Further, debentures may be issued

(i) at par, (ii) at premium, and (iii) at discount

Accounting treatment of issue of debentures for cash

1. Debentures Issued for Cash at Par :

Following journal entries will be made :

(i) Application money is received

Bank A/c Dr.

To Debentures Application A/c

(Application money received for Debentures)

(ii) Transfer of debentures application money to debentures account on allotment of debentures

Debentures Application A/c Dr.

To Debentures A/c

(Application money transferred to debenture account on allotment)

(iii) Money due on allotment

Debentures Allotment A/c Dr.

To Debentures A/c

(Allotment money made due)

(iv) Money due on allotment is received

Bank A/c Dr.

To Debentures Allotment A/c

(Receipt of Debenture allotment money)

(v) First and final call is made

Debentures First and Final call A/c Dr.

To Debentures A/c

(First and Final call money made due on .... debentures)

(vi) Debentures First and Final call money is received

Bank A/c Dr.

To Debentures First and Final call A/c

(Receipt of Amount due on call)

Note : Two calls i.e. first call and second call may be made Journal entries will be made on the lines made for first and final call.

Illustration 1

Shining India Ltd. issued 5000, 8% Debentures of ₹ 100 each payable as follows

₹ 20 on Application

₹ 30 on Allotment

₹ 50 on First and Final call

All the debentures were applied for and allotted. All the calls were duly received. Make necessary journal entries in the books of the company.

Solution :

Shining India Ltd.

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr. To 8% Debentures Application A/c (Application money received for 5000 debentures)		1,00,000	1,00,000
2.	8% Debentures Application A/c Dr. To 8% Debentures A/c (Application money transferred to Debentures A/c on allotment)		1,00,000	1,00,000
3.	8% Debentures Allotment a/c Dr. To 8% Debentures A/c (Allotment money due on 5000 debentures @ ₹ 30 per debenture)		1,50,000	1,50,000
4.	Bank A/c Dr. To 8% Debentures Allotment A/c (Allotment money received)		1,50,000	1,50,000
5.	8% Debentures First and Final call A/c Dr. To 8% Debentures A/c (Debentures first and final call money made due @ ₹ 50 per debenture)		2,50,000	2,50,000
6.	Bank A/c Dr. To Debentures First and Final call A/c (Receipt of 8% Debentures first and final call money)		2,50,000	2,50,000

Over Subscription

If the company receives applications for number of debentures that exceed the number of debentures offered for subscription, it is called over subscription. The excess application money received can be treated as follows :

(a) The total amount of excess number of applications is refunded in case the applications are totally rejected.

(b) The amount of excess application money is totally adjusted towards amount due on allotment and calls

- in case partial allotment is made,
- the excess amount is adjusted towards sums due on allotment and rest of the amount is refunded.

Journal entries in the above cases will be as follows :

For refund of money if the applications are rejected

Debentures Application A/c Dr.
To Bank A/c
(Refund of money on rejected applications)

For adjustment of excess application money adjusted towards sum due on allotment

Debentures Application A/c Dr.
To Debentures Allotment A/c
(Excess application money adjusted)

Illustration 2

ABC Ltd issued 5000 10% Debentures of ₹ 100 each payable as ₹ 40 on application and ₹ 60 on allotment. Applications were received for 6000 debentures. Applicants for 500 debentures were sent letter of regret and money was returned. Allotment was made proportionately to the remaining applicants. Over subscription was applied to the amount due on allotment. Remaining amount was duly received.

Make journal entries for the above transactions in the books of the company.

Solution :

Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr To 10% Debentures Application A/c (Application money received for 6000 10% debentures @ ₹ 40 per debenture)		2,40,000	2,40,000

Notes

2.	10% Debentures Application A/c	Dr		2,40,000	
	To 10% Debentures A/c				2,00,000
	To Bank A/c				20,000
	To 10% Debentures Allotment A/c				20,000
	(Debenture application money of 5000 debentures transferred to debenture A/c on their allotment of 500 debentures returned and balance of 500 adjusted towards allotment)				
3.	10% Debentures Allotment A/c	Dr		3,00,000	
	To 10% Debentures A/c				3,00,000
	(Allotment money due on 5000 debentures @ ₹ 60 per debenture)				
4.	Bank A/c	Dr		2,80,000	
	To 10% Debentures Allotment A/c				2,80,000
	(Allotment money received)				

INTEXT QUESTIONS 30.2

i. List the various forms in which debentures can be issued

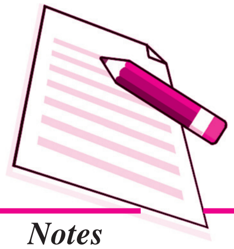
a) ________________________________

b) ________________________________

ii. A company issued 10000 10% debentures of ₹ 100 each. ₹ 30 per debenture was to be paid along with application. Applications were received for 12000 debentures. What can the company do with the excess application money i.e. ₹ 60000 (2000 × ₹ 30)

30.3 ISSUE OF DEBENTURES AT PREMIUM AND AT DISCOUNT

Debentures are said to be issued at premium when these are issued at a value which is more than their nominal value. For example, a debenture of ₹ 100 is issued at ₹ 110. This excess amount of ₹ 10 is the amount of premium. The premium on the issue of debentures is credited to the Securities Premium A/c as per section 78 of the Companies Act, 1956.



Notes

Journal entry will be as follows :

Debentures Allotment A/c Dr.
To Debentures Account
To Securities Premium A/c
(Amount due on allotment alongwith premium of ₹ ....)

Illustration 3

A company issued 5000 10% Debentures of ₹ 100 each at a premium of 20% payable as ₹ 60 on application ₹ 60 on allotment (including premium).

All the debentures were subscribed for and money was duly received. Make journal entries.

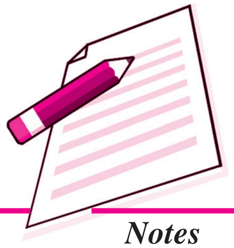
Solution :

Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr. To Debentures Application A/c (Application money received)		3,00,000	 3,00,000
2.	10% Debentures Application A/c Dr. To 10% Debentures A/c (Application money transferred to Debenture A/c)		3,00,000	 3,00,000
3.	Debentures Allotment A/c To 10% Debentures A/c To Securities Premium A/c (Amount due on allotment along with premium)		3,00,000	 2,00,000 1,00,000
4.	Bank A/c Dr. To 10% Debentures Allotment A/c (Allotment money received)		3,00,000	 3,00,000

Issue of Debentures at Discount

When debentures are issued at less than their nominal value they are said to be issued at discount. For example, debenture of ₹ 100 each is issued at ₹ 90 per debenture. Companies Act, 1956 has not laid down any conditions for the issue of debentures at a discount as have been laid down in case of issue of shares at discount. However, there should be provision for issue of such debentures in the Articles of Association of the Company.



Notes

Journal entry for issue of debentures at discount (at the time of allotment)

Debentures Allotment A/c Dr.

Discount on issue of debentures A/c Dr.

To Debentures A/c

(Allotment money due. The amount of discount is @ ₹ .... per debenture)

Illustration 4

A company has issued 2000 9% debentures of ₹ 100 each at a discount of 10% payable as

₹ 40 on application

₹ 50 on allotment

Make necessary journal entries.

Solution :

Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Bank A/c Dr.		80,000	
	To 9% Debentures Application A/c			80,000
	(Application money received)			
2.	9% Debentures Application A/c Dr.		80,000	
	To 9% Debentures A/c			80,000
	(Application money transferred to debenture A/c)			

Notes

3.	9% Debentures Allotment A/c	Dr.		1,00,000	
	Debentures Discount A/c	Dr.		20,000	
	To 9% Debenture A/c				1,20,000
	(Amount due on allotment, along with discount amount ₹ 10 per debenture)				
4.	Bank A/c	Dr.		1,00,000	
	To 9% Debentures Allotment				1,00,000
	(Receipt of allotment money)				

Issue of Debentures for Consideration Other than Cash

When a company purchases some assets and issues debentures as a payment for the purchase, to the vendors it is known as issue of debentures for consideration other than cash. Debentures can be issued to vendors at par, at premium and at discount

Accounting Treatment :

1. Purchase of Assets

Sundry Assets A/c (Individually) Dr.
To Vendors A/c
(Purchase of assets)

2. Allotment of debentures

(i) At par

Vendors' A/c Dr.
To Debentures A/c
(issue of debentures at par to vendors)

(ii) At discount

Vendors' A/c Dr.
Debentures Discount A/c Dr.
To Debentures A/c
(Issue of debentures to vendors at a discount of ₹ ... per debenture)

(iii) At premium

Vendors' A/c Dr
To Debentures A/c
To Securities Premium Reserve A/c
(Issue of debentures to vendors at a premium of ₹ .... per debenture)

Illustration 5

M.B. Electronics Ltd. purchased machinery for ₹ 1,98,000 and issued 9% debentures of ₹ 100 each to the vendors. Make journal entries if the debentures were issued

(a) at par

(b) at a premium of ₹ 10

(c) at a discount of ₹ 10

Solution :

S.No.	Particulars		L.F.	Dr. ₹	Cr. ₹
	Machinary A/c	Dr.		1,98,000	
	To Vendors A/c				1,98,000
	(Machine purchased)				
(a)	Vendors A/c	Dr.		1,98,000	
	To 9% Debentures A/c				1,98,000
	(1980 debentures of ₹ 100 each issued to vendors)				
(b)	Vendors A/c	Dr.		1,98,000	
	To 9% Debentures A/c				1,80,000
	To Securities Premium Reserve A/c				18,000
	(1800 debentures issued at a premium of ₹ 10 per debenture)				
(c)	Vendors A/c	Dr.		1,98,000	
	Discount on Issue of Debentures A/c	Dr.		22,000	
	To 9% Debentures A/c				2,20,000
	(Issue of 2200 9% debentures of ₹ 100 each at a discount of ₹ 10 per debenture)				

Working Notes

Amount due = ₹ 198000

Value of debenture including ₹ 10 for premium = ₹ 110

$$\text{No. of debentures to be issued} = \frac{₹1,98,000}{₹110} = ₹\ 1,800$$

∴ Debenture amount (Nominal value) = 1800 × 100 = ₹ 1,80,000

Securities Premium Amount = 1800 × ₹ 10 = ₹ 18,000

Working Notes

Amount due to vendor = ₹ 1,98,000

Value of one debenture at a discount of ₹ 10 = ₹ 90

No. of debentures to be issued= ₹ 1,98,000 ÷ ₹ 90 = ₹ 2,200

Debentures amount (Nominal value) = 2200 × ₹ 100 = ₹ 2,20,000

Discount on issue of Debentures = 2200 × ₹ 10 = ₹ 22,000

Issue of Debentures with conditions Stipulated to their Redemption (Journal entry)

Issued at par redeemable at par

(i) Bank A/c Dr.

To Debentures Application Account

(Issue of debentures of ₹ .... at par)

(ii) Debentures Application Dr.

To Debentures A/c

(Debentures application amount transferred to debentures account)

Issued at discount and redeemable at par

(i) Bank A/c Dr.

To Debentures A/c

(Issue of debentures of ₹ ... at a discount of ₹ ....)

(ii) Debentures A/c Dr.

Discount on issue of Debentures A/c Dr.

To Debentures Account

(Debentures application amount transferred to debentures account)

Issued at premium redeemable at par

(i) Bank A/c Dr.

To Debentures Application A/c

(Issue of ... debentures of ₹ .... at a premium of ₹ ....)

(ii) Debentures Application Dr.

To Debentures A/c

To Securities Premium A/c

(Debenture Application amount transferred to debenture account)

Issue at par, redeemable at premium

(i) Bank A/c Dr

To Debentures A/c

(Issue of ... debentures of ₹ ... a redeemable at a premium of ₹ ...)

(ii) Debentures Application A/c Dr

Loss on issue of Debentures A/c Dr

To Debentures A/c

To Premium on Redemption of Debentures

(Debenture application amount transferred to debenture A/c & recognised loss on issue)

Issued at discount and redeemable at premium

(i) Bank A/c Dr

To Debentures Application A/c

(issue of ... debentures of ₹ ... at a discount of ₹ ... redeemable at a premium of ₹ ....)

(ii) Debentures Application A/c Dr

Discount on issue of Debenture A/c Dr

Loss on issue of Debentures Dr

To Debentures A/c

To Premium on Redemption of Debentures

(Transferred debentures approving to Debentures A/c & recognised loan on issue of debentures)

Illustration 6

Make journal entries if 200, 9% debentures of ₹ 500 each have been issued as :

(i) Issued at ₹ 500, redeemable at ₹ 500

(ii) Issue at ₹ 450; redeemable at ₹ 500

(iii) Issued at ₹ 550; redeemable at ₹ 500

(iv) issued at ₹ 500; redeemable at ₹ 550

(v) Issued at ₹ 450; redeemable at ₹ 550

Notes

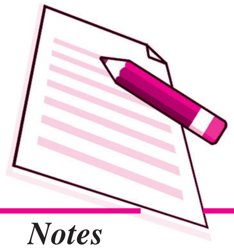
Solution :

Journal

S.No.	*Particulars*		*L.F.*	*Dr.* ₹	*Cr.* ₹
(i)	(a) Bank A/c	Dr.		1,00,000	
	To Debenture Application A/c				1,00,000
	(Received application for issue of 200, 9% debentures)				
	(b) Debenture Application A/c			1,00,000	
	To 9% Debentures A/c				1,00,000
	(9% debentures application amount transferred to 9% debentures a/c on allotment)				
(ii)	(a) Bank A/c	Dr.		90,000	
	To Debenture application A/c				1,00,000
	(Received application for issue of 200 debentures of ₹ 50 each at ₹ 450)				
	(b) Debentures Application A/c	Dr.		90,000	
	Discount on issue of 9% Debentures A/c	Dr.		10,000	
	To 9% Debentures A/c				1,00,000
	(Transferred 9% Debentures Application amount to 9% Debentures A/c on allotment of Debentures)				
(iii)	(a) Bank A/c	Dr.		1,10,000	
	To Debentures Application A/c				1,00,000
	To Securities Premium Reserve A/c				10,000
	(Received application for 200 debentures of ₹ 500 each at ₹ 550)				

Notes

	(b) Debentures Application A/c Dr. To 9% Debentures A/c To Securities Premium (9% Debentures Application amount transferred to 9% Debentures A/c & Securities Premium A/c on allotment of 9% Debentures)		1,10,000	 1,00,000 10,000
(iv)	(a) Bank A/c Dr. To Debentures Application A/c (Issue of 200 debentures of ₹ 500 each at ₹ 500 repayable at ₹ 550)		1,00,000	 1,00,000
	(b) Debentures Application A/c Dr. Loss on issue of debenture A/c Dr. To 9% debentures A/c To Premium on redemption of Debentures A/c (9% Debentures Application money transferred to 9% debentures a/c & accounted for loss on issue of debs.)		1,00,000 10,000	 1,00,000 10,000
(v)	(a) Bank A/c Dr To Debentures Application A/c (Issue of 200 Debentures of ₹ 500 each at ₹ 450 each)		90,000	 90,000
	(b) Debentures Application A/c Dr. Loss on Issue of Debentures A/c Dr. To 9% Debentures A/c To Premium on Redemption A/c (9% Debentures Application money transferred to 9% debentures a/c & accounted for loss on issue of debs.)		90,000 20,000	 1,00,000 10,000



Notes

INTEXT QUESTIONS 30.3

I. A company purchased a building for ₹ 3,15,000 and issued 10% debentures of ₹ 100 each at a premium of 5%. Calculate

(i) the number of debentures issued to the vendors

(ii) make journal entry for the issue.

II. Fill in the blanks with appropriate word/words, figure/figures

(i) A 10% debenture of nominal value of ₹ 100 has been issued at ₹ 90 is said to be issued at ....

(ii) A 9% debenture of a nominal value of ₹ 100 has been issued at ₹120 debentures are said to be issued at ....

(iii) 100 8% debentures of ₹ 100 each has been issued to vendors for plant purchased the debentures are said to be issued ....

(iv) A company can issue its debentures at a discount if a provision in this regard has been made in its ....

30.4 ISSUE OF DEBENTURES AS COLLATERAL SECURITY

Collateral security means security given in addition to the principal security. It is a subsidiary or secondary security. Whenever a company takes loan from bank or any financial institution it may issue its debentures as secondary security which is in addition to the principal security. Such an issue of debentures is known as 'issue of debentures as collateral security'. The lender will have a right over such debentures only when company fails to pay the loan amount and the principal security is exhausted. In case the need to exercise this right does not arise, debentures will be returned back to the company. No interest is paid on the debentures issued as collateral security because company pays interest on loan.

In the accounting books of the company issue of debentures as collateral security can be credited in two ways.

(i) No journal entry to be made in the books of accounts of the company

Journal entries are not passed in the books, however, debentures issued as collateral security are shown by way of information in Note to Accounts below Long-term Borrowings under Non-Current Liabilities if issued for obtaining Long-term Loans or below Short-term.

Borrowing under current liabilities if issued for obtaining short-term loans.

Illustration 7

On 30.9.2014 X Ltd. obtained a bank loan of ₹ 8,00,000 prepayable after 5 years. For this the company issued 9% debentures as collateral security. Show the loan in the balance sheet of the company and prepare 'note to acounts'.

Solution :

X Ltd.
Balance Sheet
as at 31.3.2014

Particulars	*Note No.*	₹
I. EQUITY AND LIABILITIES		
Non-Current Liabilities		
Long Term Borrowings	1	8,00,000

Note to Accounts

Long-Term Borrowing

Bank Loan	8,00,000

(Secured by issue of 9% debentures as collateral security)

Illustration 8

On 1.3.2014 Y Ltd. obtained a short term loan for ₹ 10,00,000. The company issued 12,000, 9% debentures of ₹ 100 each as collateral security for the same. Show loan in the balance sheet of Y Ltd and prepare 'note to account'.

Solution :

Y Ltd.
Balance Sheet
as at 31.3.2014

Particulars	*Note No.*	₹
I. EQUITY AND LIABILITIES		
Current Liabilities Shot-term Borrowings	1	10,00,000

Note to Accounts

Short-Term Borrowing

Bank Loan 10,00,000

(Secured by issue of 12,000, 9% debentures of ₹ 100 each as collateral security)

(ii) Entry to be made in the books of account the company

A journal entry is made on the issue of debentures as a collateral security, Debentures suspense A/c is debited because no cash is received for such issue.

Following journal entry will be made

Debenture Suspense A/c Dr.

To Debentures A/c

(.....Debentures of ₹ .... each issued as collateral security to .....)

When the loan is paid this entry is cancelled by means of a reverse entry. In the Balance Sheet, debentures issued as collateral security are distinguished from other debentrues.

Debentures issued as colletral security are related to the loan, therefore, they are shown in the same 'note to accounts' in which the loan secured by debentures is shown. For example if the loan is shown as Long-term Borrowings, debentures issued as collateral securities are also shown as long-term borrowings under Non-Current Liabilities in the Equity and Liabilities part of the Balance Sheet.

Illustration 9

XY Ltd obtained a term loan of ₹ 8,00,000 from bank on 1.1.1014 and issued ₹ 10,00,000, 9% debentures of ₹ 100 each as collateral security. Pass necessary journal entries, prepare Balance Sheet and Note to Account.

Solution :

Journal Entries

S.No.	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Bank A/c Dr.		8,00,000	
	To Bank Loan A/c			8,00,000
	(Obtained loan ₹ 8,00,000 from bank)			

	Debenture Suspense A/c Dr.		10,00,000	
	To 9% Debentures A/c			10,00,000
	(Issued 9% Debentures as collateral security for obtaining loan)			

XY Ltd.

Balance Sheet

as at 31.3.2014

Particulars	*Note No.*	₹
I. EQUITY AND LIABILITIES		
Long-Term Borrowings	1	8,00,000

Note to Accounts

Long-Term Borrowing

Loan from Bank		8,00,000
1,000, 9% Debentures of ₹ 100 each	10,00,000	
Issued as collateral Security		
(Less Debenture Suspense)	10,00,000	
		8,00,000

INTEXT QUESTIONS 30.4

Answer the following in one word/words :

(i) Name the security which is issued in addition to the principal security.

(ii) Which account is debited while making a journal entry in the books of the company on issue of debentures as collateral security.

(iii) On which side of the balance sheet of a company issuing debentures as collateral security is written the Debentures Suspense A/c?

(iv) When does a company issue debentures as collateral security ?

30.5 DISCOUNT ON ISSUE OF DEBENTURES AND LOSS ON ISSUE OF DEBENTURES

In case company issues debentures on discount the total amount of discount is not charged to profit and Loss Account of the company in the accounting year in which this discount is allowed. The amount of such discount is very heavy and to the company gets benefit from the loan by issuing debentures over a number of years. Hence some part of the amount of discount is written off every year. Generally it is written off prior to the redemption of these debentures.

As the amount of discount on issue of debentures is treated as a capital loss, it is shown on the asset side of the balance sheet of the company under the head "Miscellaneous Expenditure" until and by the amount it is not written off.

The amount of debenture discount can be written off in two ways :

1. All debentures are to be redeemed after a fixed period

When the debentures are to be redeemed after a fixed period, the amount of discount will be distributed equally within the number of years spreaded between the issue of debentures and their redemption. The amount of discount on issue of debentures to be written off each year is calculated as

Amount of discount to be written off annually =

$$\frac{\text{Amount of discount on issue of debentures}}{\text{No. of years after which debs. have to be redeemed}}$$

Illustration 10

A company issues 1000 debentures of ₹ 1000 each at a discount of 10% redeemed after 5 years. Calculate the amount of discount to be written off each year and prepare discount on issue of debentures account.

Solution :

$$\text{Amount of discount} = \frac{(1{,}000 \times ₹1{,}000) \times 10}{100} = ₹\ 1{,}00{,}000$$

$$\text{Amount to be written off each year} = \frac{₹1{,}00{,}000}{5} = ₹\ 20{,}000$$

Accounting Treatment

Journal entry to write off discount on debentures will be.

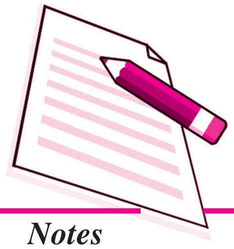
	Particulars	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Profit and Loss A/c Dr.		20,000	
	To Discount on Issue of Debentures A/c			20,000
	(Amount of Discount on Issue of Debentures written off)			

Discount on Issue of Debentures Account till the amount of discount is written off, is shown as under :

Discount on Issue of Debentures A/c

Dr. Cr.

Date	*Particulars*	*Amount* ₹	*Date*	*Particulars*	*Amount* ₹
	1st year			**1st year**	
Jan 1	Debenture A/c	1,00,000	Dec 31	Profit & Loss A/c	20,000
			Dec 31	Balance cld	80,000
		1,00,000			1,00,000
	2nd year			**2nd year**	
Jan 1	Balance b/d	80,000	Dec. 31	Profit & Loss A/c	20,000
			Dec.31	Balance cld	60,000
		80,000			80,000
	3rd year			**3rd year**	
Jan 1	Balance b/d	60,000	Dec 31	Profit & Loss A/c	20,000
			Dec 31	Balance cld	40,000
		60,000			60,000
	4th year			**4th year**	
Jan 1	Balance b/d	40,000	Dec 31	Profit & Loss A/c	20,000
			Dec 31	Balance cld	20,000
		40,000			40,000



Notes

	5th year			**5th year**	
Jan 1	Balance b/d	20,000	Dec 31	Profit & Loss A/c	20,000
		20,000			20,000

2. Debentures are redeemed in instalments

Debentures may also be redeemed in instalments but over a fixed period. In that case the amount of debenture discount will be written off each year in proportion to the amount of debentures outstanding at the end of each year.

Illustration 11

A company has issued 3000 9% debentures of ₹ 1,000 each at a discount of 10%. If the debentures are to be redeemed in five equal annual instalments, calculate the amount of Discount on Issue of Debentures to be written off each year and prepare Discount on Issue of Debentures A/c.

Solution :

Calculation of Amount of Discount on Issue of Debentures Account

Total amount of Discount on Issue of Debentures A/c

$$= \frac{10}{100} \times 3{,}000 \times 1{,}000 = ₹\ 3{,}00{,}000$$

Year end	*Outstanding amount of debenture* ₹	*Ratio*	*Amount of Discount written off* ₹
1st	30,00,000	5	$3{,}00{,}000 \times \frac{5}{15} = 1{,}00{,}000$
2nd	24,00,000	4	$3{,}00{,}000 \times \frac{4}{15} = 80{,}000$
3rd	18,00,000	3	$3{,}00{,}000 \times \frac{3}{15} = 60{,}000$
4th	12,00,000	2	$3{,}00{,}000 \times \frac{2}{15} = 40{,}000$
5th	6,00,000	1	$3{,}00{,}000 \times \frac{1}{15} = 20{,}000$
		15	

Notes

Journal Entry

	Particulars	*L.F.*	*Dr.* ₹	*Cr.* ₹
1st year	Profit and Loss A/c Dr.		1,00,000	
	To Debenture Discount A/c			1,00,000
	(Discount on issue of debenture written off)			

Similarly entry will be made every year with the respective amount of discount.

Discount on issue of Debentures Account till the amount of discount is written off will be shown as under.

Discount on Issue of Debentures A/c

Dr. Cr.

Date	*Particulars*	*Amount* ₹	*Date*	*Particulars*	*Amount* ₹
	1st year			**1st year**	
Jan 1	Debentures A/c	3,00,000	Dec 31	Profit & Loss A/c	1,00,000
			Dec 31	Balance cld	2,00,000
		3,00,000			3,00,000
	2nd year			**2nd year**	
Jan 1	Balance b/d	2,00,000	Dec. 31	Profit & Loss A/c	80,000
			Dec.31	Balance cld	1,20,000
		2,00,000			2,00,000
	3rd year			**3rd year**	
Jan 1	Balance b/d	1,20,000	Dec 31	Profit & Loss A/c	60,000
			Dec 31	Balance cld	60,000
		1,20,000			1,20,000
	4th year			**4th year**	
Jan 1	Balance b/d	60,000	Dec 31	Profit & Loss A/c	40,000
			Dec 31	Balance cld	20,000
		60,000			60,000

Notes

	5th year			**5th year**	
Jan 1	Balance b/d	20,000	Dec 31	Profit & Loss A/c	20,000
		20,000			20,000

Loss on Issue of Debentures

You have learnt that a company may issue debentures with the stipulation that the repayment of the debentures on maturity will be made at premium. The amount of the premium payable is debited to Loss on Issue of Debentures Account at the time of issue of debentures. This amount will also be written off in the same manner as is done in case of writing off Discount on Issue of Debentures. This is illustrated as under :

(i) All Debentures are redeemed after fixed period

Journal Entry

Amount of Loss on Issue of Debentures written off each year

Profit and Loss A/c Dr.

To Loss on Issue of Debentures A/c

(Loss on Issue of Debentures written off)

Same journal entry will be made each year till the whole amount of the Loss on issue of Debentures is written off.

Calculation of the amount to be written off Total Amount of Loss on Issue of Debentures/No. of years.

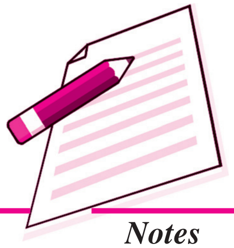
Illustration 12

A company issues 1000 10% Debentures of ₹ 1,000 each on 1st Jan, 2014 payable at a premium of 10% after 5 years. Make journal entries and open Loss on Issue of Debentures A/c for the year ending 31st December 2014.

Solution :

$$\text{Amount of Loss on issue of Debentures} = \frac{1000 \times ₹1{,}000 \times 10}{100} = ₹\ 1{,}00{,}000$$

$$\text{Amount to be written off each year} = \frac{₹1{,}00{,}000}{5} = ₹\ 20{,}000$$



Notes

Loss on Issue of Debentures A/c

Dr. Cr.

Date	*Particulars*	*Amount* ₹	*Date*	*Particulars*	*Amount* ₹
2014			2014		
Jan. 1	10% Debentures A/c	1,00,000	Dec. 31	Profit & Loss A/c	20,000
			Dec. 31	Balance c/d	80,000
		1,00,000			1,00,000
2015					
Jan. 1	Balance b/d	80,000			

Journal Entry

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
2014				
Dec. 31	Profit and Loss A/c Dr.		20,000	
	To Loss on Issue of Debentures A/c			20,000
	(Loss on Issue of Debentures transferred to Profit and Loss A/c)			

(ii) Debentures are Redeemed in Instalments

The amount of Loss on Issue of Debentures to be written off each year is calculated in the manner it is calculated in case of Discount on Issue of Debentures and accounting treatment is also the same.

Illustration 13

Refer Illustration No. 10. A company decides to redeem its debentures in five equal instalments beginning from the end of first year. Make journal entry for the writing off and show Loss on Issue of Debentures A/c for first year.

Solution :

$$\text{Amount of Loss on Issue of Debentures} = \frac{1000 \times ₹1,000 \times 10}{100} = ₹\ 1,00,000$$

Calculation of amount to be written off each year

Year end	*Amount Outstanding* ₹	*Ratio*	*Amount of Loss to be written off each year (₹)*
1st	10,00,000	5	$1,00,000 \times \frac{5}{15} = 33,333$
2nd	8,00,000	4	$1,00,000 \times \frac{4}{15} = 26,667$
3rd	6,00,000	3	$1,00,000 \times \frac{3}{15} = 20,000$
4th	4,00,000	2	$1,00,000 \times \frac{2}{15} = 13,333$
5th	2,00,000	1	$1,00,000 \times \frac{1}{15} = 6,667$
		15	

Journal Entry

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
2014 Dec 31	Profit and Loss A/c Dr. To Loss on Issue of Debentures A/c (Amount of Loss on Issue of Debentures written off for 2014)		33,333	33,333

Loss on Issue of Debentures A/c

Dr. Cr.

Date	*Particulars*	*Amount* ₹	*Date*	*Particulars*	*Amount* ₹
2014 Jan 1	10% Debentures A/c	1,00,000	2014 Dec 31	Profit & Loss A/c	33,333
			Dec 31	Balance cld	66,667
		1,00,000			1,00,000
2015 Jan 1	Balance b/d	66,667			

Interest on Debentures

If you have seen an advertisement in newspaper regarding issue of debentures by a company, you must have noticed that 'Debenture' is always prefixed by a certain percentage say 9% Debentures or 12% Debentures. Have you ever thought what meaning does this prefix carry. It is the rate of interest per annum that will be paid to the debenture holders. Companies generally pay interest on its debentures after every six months. Income Tax on such interest in deducted at source by the company Journal entries that are made in the books of the company are as follows :

(i) Interest due on Debentures

Debenture Interest A/c Dr.
  To Debentures Holder's A/c
  To Income Tax Payable A/c
(Interest on ....% Debentures due for six months ending ...@ ....% pa)

(ii) For Payment of Interest

Debentures Holders A/c Dr.
Income Tax Payable Dr.
  To Bank

(iii) Transfer of Debenture Interest to Profit and Loss A/c

Profit and Loss A/c Dr.
  To Debenture Interest A/c
(Debenture Interest transferred to Profit and Loss A/c)

Illustration 14

X Ltd has issued 5000 9% Debentures of ₹ 1,000 each, on 1st April, 2013 Interest is payable after every six months. The ratio of TDS is 10%. Make journal entries for the interest paid for the first six months after the date of issue.

Solution :

Calculation of Interest payable at six monthly intervals :

$$\frac{\text{Amount of Debentures} \times 9}{100} \times \frac{6}{12}$$

Amount of Debentures = 5000 × ₹ 1,000 = ₹ 50,00,000

Interest on Debentures for six month ending 30th September, 2013

= = ₹ 2,25,000

Journal Entry

Date	*Particulars*		*L.F.*	*Dr.* ₹	*Cr.* ₹
2013					
Sept. 30	Debentures Interest A/c	Dr.		2,25,000	
	To Debenture Holder's A/c				2,02,500
	To Tax Payable				22,500
	(Interest on 5000 9% Debentures @ ₹ 1000 per debenture paid for 6 months ending 30th Sept 2006)				
Sept. 30	Debenture Holders A/c	Dr.		2,02,500	
	Tax Payable	Dr.		22,500	
	To Bank				2,25,000
	(Paid interst to debenture holder's tax to government)				
2014					
Mar. 31	Profit and Loss A/c	Dr.		2,25,000	
	To Debentures Interest A/c				2,25,000
	(Debenture Interest transferred to profit and Loss A/c)				

INTEXT QUESTIONS 30.5

Answer the following :

(i) Why is the amount of Discount on Issue of Debentures written in the Balance sheet ?

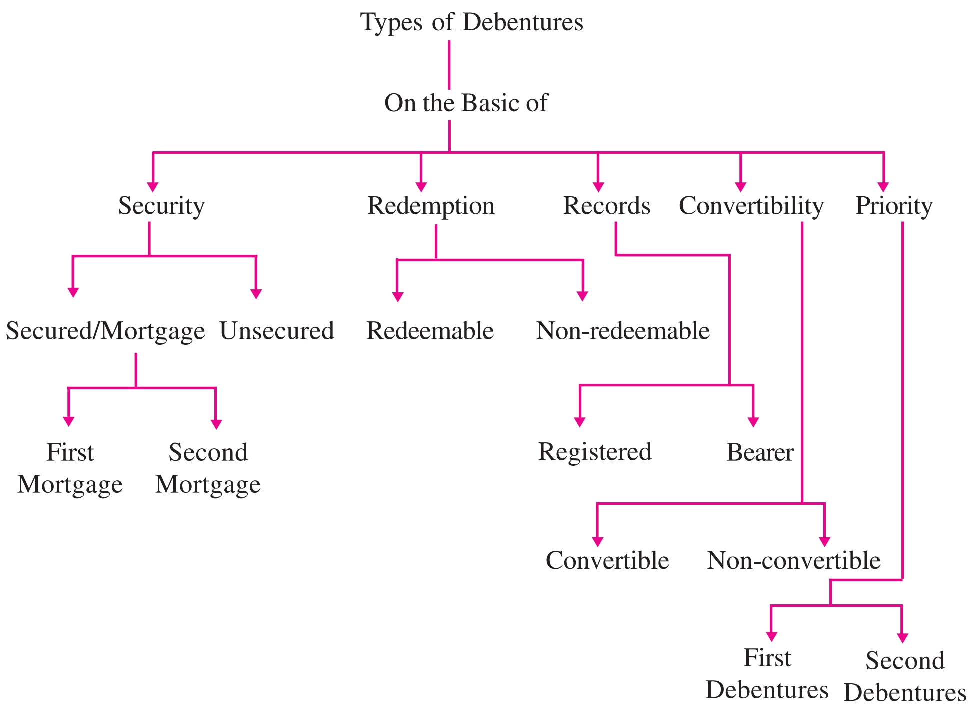
(ii) 1000 10% Debentures are issued at a discount of 10% to be redeemed after five years. Calculate the amount of Debenture Discount to be written off each year.

(iii) 5000 10% Debentures of ₹ 100 each were issued by company on 1 Jan. 2014. Interest is payable on 30 June & 31 Decembers each year. Calculate the amount of interest paid to debenture holders during 2015.

WHAT YOU HAVE LEARNT

- A Debenture is a unit of loan amount issued to the lenders of the company. Debenture includes debenture stock, bond and any other security whether constituting a charge on the company's assets or not.

  Debentures can be classified on the basis of :



- Issue of debentures : Debentures can be issued for cash at par, for consideration other than cash, as collateral security debentures are said to be oversubscribed when the company receives application for number of debentures than the company has offered for subscription.

  Debenture can be issued at premium, at discount and in consideration other than cash.

Notes

- Debentures can be issued with conditions stipulated to their redemption as:
  - Issued at par redeemable at par
  - Issued at discount redeemable at par
  - Issued at premium redeemable at par
  - Issued at par redeemable at premium
  - Issued at discount redeemable at premium
- Issue of debentures as collateral security means issuing debentures to the lending agency that has given loan as additional/secondary security.

TERMINAL EXERCISE

1. What do you mean by debenture? State in brief the various types of debentures.
2. When are debentures said to be over subscribed? What accounting treatment is given in case debentures are oversubscribed?
3. What is the accounting treatment in the following cases :
   (a) Debentures are issued at premium
   (b) Debentures are issued at discount
   (c) Debentures are issued in consideration other than cash
4. What is meant by debentures issued as collateral security? How is it treated in the books of accounts of the company?
5. Explain debentures issued at a discount. How is the amount of discount treated in the books of the company?
6. MBS Company Ltd has issued 5000 9% debentures of ₹ 100 each at a premium of ₹ 20 per debenture payable ₹ 60 (including premium) on application and allotment and the balance on call. Applications were received for 6500 debentures. Applications for 500 debentures were outrightly rejected and allotment was made on prorata basis to the remaining applicants.

   All the money was duly called up. Make journal entries for the issue in the books of the company.

Notes

7. New Ventures Ltd. purchased plant of the book value of ₹ 4,95,000 from another firm. The purchase consideration was paid by issuing 10% debentures of ₹ 100 each. Assume debentures have been issued, (i) at par, (ii) at discount of 10%, (iii) at premium of 10%.

8. XYZ Co Ltd. has purchased the business of ABC Ltd. consisting assets of ₹ 4,50,000 and liabilities of ₹ 1,50,000 for a consideration of ₹ 4,00,000. It issued 10% debentures of ₹ 100 each fully paid in satisfaction of purchase consideration. Make journal entries.

9. Gasping Furnishing and Decoration Ltd. raised a secured loan of ₹ 10,00,000 from State Bank of India and issued 1,500 10% debentures of ₹ 1,000 each as collateral security. Give the treatment of issue of such debentures in the books of the company.

10. Make journal entries for the issue of 10% debentures of ₹ 100 each in the following cases :
    (a) 4,000 debentures issued at ₹ 100, redeemable at ₹ 120
    (b) 2,000 debentures issued at ₹ 120, redeemable at ₹ 100
    (c) 5,000 debentures issue at ₹ 90, redeemable at ₹ 100
    (d) 6,000 debentures issued at ₹ 90, redeemable at ₹ 110
    (e) 2,000 debentures issued at ₹ 100, redeemable at ₹ 100

11. On 1st January, 2014 a limited company issued its 1000000 debentures at a discount of 6%. The debenture were repayable by annual drawings of ₹ 2,00,000 made on 31st December each year. The discount was to be written off each year with an amount proportionate to debentures outstanding in the year.

    Show the discount on issue of Debentures Account in the company ledger till it is written off.

12. High Rise Builders Ltd. issued 10% debentures of ₹ 100 each valued at ₹ 6,00,000 at discount of 6% repayable at par in equal proportions at the end of 2nd, 3rd and 5th year. Calculate the amount of discount to be written off at the end of each year and prepare discount on issue of debentures account.

13. AB Ltd issued 1000 12% debentures of ₹ 1,000 each on 1st January 2014. Make journal entries for the year ended 31st December 2014 assuming that interest was payable yearly on 31st December and tax deducted at source is @10%.

Notes

ANSWERS TO INTEXT QUESTIONS

30.1 (i) Redeemable; Non-redeemable (ii) Registered; Bearer

(iii) Convertible; Non-convertible (iv) First; Second

30.2 I. (i) Issued for cash (ii) Issued in consideration other than cash

(iii) Issued as collateral security

II. (a) Application money is received

(b) Application money is adjusted towards subsequent calls

30.3 I. 3,000

Vendors A/c	Dr.	3,15,000	
To 10% Debentures A/c			3,00,000
To Securities Premium A/c			15,000

II. (i) Discount (ii) Premium

(iii) for considerations other than cash

(iv) Articles of Association

30.4 (i) Collateral security (ii) Debenture suspense A/c

(iii) Assets side (iv) When lender demands additional security

30.5 (i) It is treated as a capital loss (ii) ₹ 10000 ÷ 5 = ₹ 2000

(iii) ₹ 25,000 on 30 June 2015 & ₹ 25,000 on 31 Dec. 2015

ANSWERS TO TERMINAL EXERCISE

7. Number of debentures to be issued (i) 4950, (ii) 5500 (iii) 4500

8. Amount of goodwill ₹ 1,00,000

11. Discount written of 1st year ₹ 20,000, 2nd year ₹ 16,000, 3rd year ₹12,000, 4th year ₹ 8,000 and 5th year ₹ 4,000

12. Discount written of 1st year and 2nd year ₹ 10,800, 3rd year ₹ 7,200 4th and 5th year ₹ 3,600.

ACTIVITY

Procure Balance Sheets of a number of companies which have raised funds by issuing debentures. Study them and collect information about the type of debentures issued by each company. Write the name of the company and put √ mark in the appropriate column :

Name of the Company	*Type of Debentures*				
	Convertible	*Non-convertible*	*Secured*	*Unsecured*	*Collateral security*

Notes

31

FINANCIAL STATEMENTS ANALYSIS - AN INTRODUCTION

You have already learnt about the preparation of financial statements i.e. Balance Sheet and Trading and Profit and Loss Account in the module titled 'Financial Statements of Profit and Not for Profit Organisations'. In the case of a company the Trading and Profit & Loss Account is known as Statement of Profit and Loss. After preparation of the financial statements, one may be interested in analysing the financial statements with the help of different tools such as comparative statement, common size statement, ratio analysis, trend analysis, fund flow analysis, cash flow analysis, etc. In this process a meaningful relationship is established between two or more accounting figures for comparison. In this lesson you will learn about analysing the financial statements by using comparative statement, common size statement and trend analysis.

OBJECTIVES

After studying this lesson, you will be able to :

- understand the major and sub-headings of Statement of Profit & Loss and Balance Sheet.
- explain the meaning, need and purpose of financial statement analysis;
- identify the parties interested in analysis of financial statements;
- explain the various techniques and tools of analysis of financial statements.

31.1 FINANCIAL STATEMENTS OF A COMPANY

The way in which the various items of Statement of Profit and Loss and the Balance Sheet should be presented is given in schedule VI part I of the Companies Act 1956. The modified formats of both the Statements are given in Schedule VI part I is as under:

Notes

Form of Statement of Profit and Loss

Statement of Profit and Loss
for the year ended ....

Particulars	*Note No.*	*Figures for the current Reporting Period*	*Figures for the Previous Reporting Period*
I. Revenue from Operations		....	....
II. Other Income		....	....
III. **Total Revenue (I + II)**		....	....
IV. **Expenses**			
Cost of Materials Consumed		....	....
Purchases of Stock-in-Trade		....	....
Change in inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		....	....
Employees Benefit Expenses		....	....
Finance Costs		....	....
Depreciation and Amortisation Expenses		....	....
Other Expenses		....	....
Total Expenses		....	....
V. **Profit before Tax (III - IV)**		....	....
VI. *Less:* Tax		....	....
VII. **Profit or Loss for the Period (V - VI)**		....	....

It will be observed from the prescribed format that a column is prescribed for Note No. It is prescribed for the purpose of cross reference to the Note number in the Notes to Accounts where detail of the line item is given.

Statement of Profit and Loss is a financial statement that shows the performance of the company over a period of time. It shows the net result of the company *i.e.*, profit earned or loss suffered during the accounting period. It shows revenue from operations, other incomes and expenses incurred in a summarized form. Statement of Profit and Loss is similarly to the Trading and Profit & Loss Account prepared by proprietorship and partnership firms. The only difference is that it is prepared in the form of a statement and not an account.

Notes

Name of the Company ....
Balance Sheet *as at* ....

Particulars (1)	*Note No.* (2)	*Figures as at the end of the current reporting period* (3)	*Figures as at the end of the Previous reporting Period* (4)
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money Received against Share Warrants			
2. Share Application Money Pending Allotment			
3. Non-Current Liabilities			
(a) Long-term Borrowings			
(b) Deferred Tax Liabilities (Net)			
(c) Other Long-term Liabilities			
(d) Long-term Provisions			
4. Current Liabilities			
(a) Short-term Borrowings			
(b) Trade Payables			
(c) Other Current Liabilities			
(d) Short-term Provisions			
Total			
II. ASSETS			
1. Non-Current Assets			
(a) Fixed Assets			
(i) Tangible Assets			
(ii) Intangible Assets			
(iii) Capital Work-in-Progress			
(iv) Intangible Assets Under Development			
(b) Non-current Investments			
(c) Deferred Tax Assets (Net)			
(d) Long-term Loans and Advances			
(e) Other Non-current Assets			
2. Current Assets			
(a) Current Investment			
(b) Inventories			
(c) Trade Receivables			
(d) Cash and Cash Equivalents			
(e) Short-term Loans and Advances			
(f) Other Current Assets			
Total			

Notes

Balance Sheet as prescribed in schedule VI part I of the Companies Act 1956 is broadly divided into two parts :

(I) Equity and Liabilities and (II) Assets

I. EQUITY AND LIABILITIES

Equity : It is the liability of the company towards its shareholders and is called as 'Shareholders' Funds'. It includes Share Capital, Reserves & Surplus and Money Received Against Share Warrents.

Liabilities : It means external liabilities of the company or liabilities towards outsiders. In between Shareholders' Fund and Liabilities, Application Money Pending Allotment is placed as per the prescribed form of the Balance Sheet. Liabilities have further been divided into (a) Non-current Liabilities and (b) Current Liabilities.

Non-current Liabilities have been defined as liabilities which are not current liabilities. Current liability is that liability which is :

i. expected to be settled in the company's normal operating cycle; or

ii. due to be settled within 12 months after the reporting date *i.e.,* Balance Sheet date; or

iii. held primarily for the purpose of being traded; or

iv. there is no unconditional right to defer settlement for at least 12 months after the reporting date.

The various items that are presented under the various heads of liabilities are given below :

(a) Long-term Borrowings
   - (i) Debentures;
   - (ii) Bonds;
   - (iii) Term Loans;
   - (iv) Public Deposits and
   - (v) Other loans and advances

(b) Current Liabilities :
   - (i) Short-term borrowings;
   - (ii) Trade Payables;
   - (iii) Other Current Liabilities and
   - (iv) Short-term Provision.

Illustration : 1 (*Classification of Equity and Liabilities*)

State the major heads under Equity and Liabilities part of the company's Balance Sheet.

Solution :

Major heads on 'Equity and Liabilities' part are :

- Shareholders' Funds,
- Share Application Money Pending Allotment,
- Non-current Liabilities, and
- Current Liabilities

Illustration : 2 (*Classification of 'Shareholders' Funds'*)

Name the sub-heads under the head 'Shareholders' Funds'.

Solution :

(i) Share Capital,

(ii) Reserves and Surplus, and

(iii) Money Received against Share Warrants

Illustration : 3 (*Classification of 'Non-current Liabilities'*)

Name the sub-heads under the head 'Non-current Liabilities' in the Equity and Liabilities part of the Balance Sheet under Schedule VI.

Solution :

(i) Long-term Borrowings,

(ii) Deferred Tax Liabilities (Net),

(iii) Other Long-term Liabilities, and

(iv) Long-term Provisions.

Illustration : 4 (*Classification of 'Current Liabilities'*)

Name the sub-heads under the head 'Current Liabilities' in the Equity and Liabilities part of the Balance Sheet as per Schedule VI.

Solution :

(i) Short-term Borrowings,

(ii) Trade Payables,

(iii) Other Current Liabilities, and

(iv) Short-term Provisions.

Illustration : 5 (*Reserves and Surplus*)

Name **any five** items that are shown under Reserves and Surplus.

Solution :

(i) Capital Reserve,

(ii) Capital Redemption Reserve,

(iii) Securities Premium Reserve,

(iv) Debenture Redemption Reserve (DRR), and

(v) Revaluation Reserve

Illustration : 6 (*Long-term Borrowings*)

Name **any four** items that are shown under Long-term Borrowings.

Solution :

(i) Debentures/Bonds,

(ii) Term-loan from banks/other parties,

(iii) Deposits, and

(iv) Long-term Loans and Advances

Illustration : 7

Give major heads under which the following items will be shown in a company's Balance Sheet as per Schedule VI, Part I of Companies Act, 1956:

(i) Trade Payables,

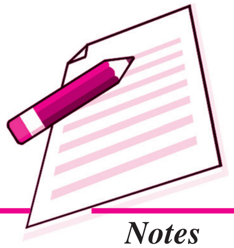
(ii) Provision for Tax,

(iii) Surplus, *i.e.*, Balance in Statement of Profit and Loss (Dr.) and

(iv) Surplus, *i.e.*, Balance in Statement of Profit and Loss.

Solution :

S.No.	*Item*	*Major Head*	*Sub-head*
(i)	Trade Payables	Current Liabilities	....
(ii)	Provision for Tax	Current Liabilities	Short-term Provisions
(iii)	Surplus, *i.e.*, Balance in Statement of Profit and Loss (Dr.)	Reserves and Surplus	As negative amount
(iv)	Surplus, *i.e.*, Balance in Statement of Profit and Loss	Reserves and Surplus	....



II. ASSETS

Like liabilities, assets are also divided into 'non-current assets' and 'current assets'. Non-current assets have been defined as assets that are not current. Current assets have been defined in Schedule VI of the Companies Act, 1956 as follows :

Current Assets are those assets which are :

i. expected to be realized in or intend for sale or consumption in the company's normal operating cycle; or

ii. held primarily for the purpose of trading; or

iii. expected to be realized within 12 months from reporting date *i.e.*, Balance Sheet date; or

iv. Cash and Cash equivalents unless they are restricted from being exchanged or used to settle a liability for at least 12 months after reporting date *i.e.,* Balance Sheet date.

Non-Current Assets are classified into the following five major heading as given below:

(a) Fixed Assets;

(b) Non-Current Investments;

(c) Deferred Tax Assets;

(d) Long-term Loans and Advances and

(e) Other non-current assets.

The items presented under these sub-heads are as follows :

1. *Fixed Assets :*

(i) Tangible Assets;

(ii) Intangible Assets;

(iii) Capital Work-in-Progress and

(iv) Intangible Assets under Development

Non-Current Investments :

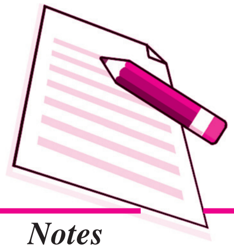
(i) Investment in Property;

(ii) Investment in Equity Investments;

(iii) Investments in preference shares;

(iv) Investment in Govt. or Trust Securities;

(v) Investments in Debentures or Bonds;



Notes

(vi) Investments in Mutual Funds;

(vii) Investments in Partnership Firms and

(viii) Other Non-Current Investments.

Lont-Term Loans and Advances :

(i) Capital Advances;

(ii) Security Deposits;

(iii) Other Loans and Advances

2. **Current Assets :** These are shown under the following six heads :

(i) Current Investments;

(ii) Inventories

(iii) Trade Receivables;

(iv) Cash and Cash Equivalents;

(v) Short term loans and advances and

(vi) Other Current Assets.

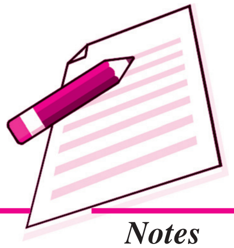
31.2 FINANCIAL STATEMENTS ANALYSIS (MEANING, PURPOSE AND PARTIES INTERESTED)

We know business is mainly concerned with the financial activities. In order to ascertain the financial status of the business every enterprise prepares certain statements, known as financial statements. Financial statements are mainly prepared for decision making purposes. But the information as provided in the financial statements is not adequately helpful in drawing a meaningful conclusion. Thus, an effective analysis and interpretation of financial statements is required.

Analysis means establishing a meaningful relationship between various items of the two financial statements with each other in such a way that a conclusion is drawn.

The term financial analysis is also known as analysis and interpretation of financial statements. It refers to the establishing meaningful relationship between various items of the two financial statements i.e., Statement of Profit & Loss and Balance Sheet. It determines financial strength and weaknesses of the firm.

Analysis of financial statements is an attempt to assess the efficiency and performance of an enterprise. Thus, the analysis and interpretation of financial statements is very essential to measure the efficiency, profitability, financial soundness and future prospects of the business units. Financial analysis serves the following purposes :



Notes

- **Measuring the Profitability :** The main objective of a business is to earn a satisfactory return on the funds invested in it. Financial analysis helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.
- **Indicating the Trend of Achievements :** Financial statements of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profits and net profit etc. can be ascertained. Value of assets and liabilities can be compared and the future prospects of the business can be envisaged.
- **Assessing the Growth Potential of the Business :** The trend and other analysis of the business provides sufficient information indicating the growth potential of the business.
- **Comparative Position in Relation to Other Firms :** The purpose of financial statements analysis is to help the management to make a comparative study of the profitability of various firms engaged in similar businesses. Such comparison also helps the management to study the position of their firm in respect of sales, expenses, profitability and utilising capital, etc.
- **Assess overall financial strength :** The purpose of financial analysis is to assess the financial strength of the business. Analysis also helps in taking decisions, whether funds required for the purchase of new machines and equipments are provided from internal sources of the business or not if yes, how much? And also to assess how much funds have been received from external sources.
- **Assess solvency of the firm :** The different tools of an analysis tell us whether the firm has sufficient funds to meet its short term and long term liabilities or not.

Parties Interested

Analysis of financial statements has become very significant due to widespread interest of various parties in the financial results of a business unit. The various parties interested in the analysis of financial statements are :

(i) **Investors :** Shareholders or proprietors of the business are interested in the well being of the business. They like to know the earning capacity of the business and its prospects of future growth.

(ii) **Management :** The management is interested in the financial position and performance of the enterprise as a whole and of its various divisions. It helps them in preparing budgets and assessing the performance of various departmental heads.

(iii) **Trade Unions :** They are interested in financial statements for negotiating the wages or salaries or bonus agreement with the management.

Notes

(iv) Lenders : Lenders to the business like debenture holders, suppliers of loans and lease are interested to know short term as well as long term solvency position of the entity.

(v) Suppliers and Trade Creditors : The suppliers and other creditors are interested to know about the solvency of the business i.e. the ability of the company to meet the debts as and when they fall due.

(vi) Tax Authorities : Tax authorities are interested in financial statements for determining the tax liability.

(vii) Researchers : They are interested in financial statements for undertaking research work in business affairs and practices.

(viii) Employees : They are interested to know the growth of profit. As a result of which they can demand better remuneration and congenial working environment.

(ix) Government and their Agencies : Government and their agencies need financial information to regulate the activities of the enterprises/industries and determine taxation policy. They suggest measures to formulate policies and regulations.

(x) Stock Exchange : The stock exchange members take interest in financial statements for the purpose of analysis because they provide useful financial information about companies.

Thus, we find that different parties have interest in financial statements for different reasons.

Limitations of Financial Analysis

Financial analysis helps the interested parties to make an assessment of the earning capacity and financial soundness of a business enterprise. But such analysis has its own limitations. Such limitations should be kept in mind while using the informations provided by the financial analysis. Some of the limitations are as follows :

(i) Limitations of Financial Statements : Financial analysis is based on financial statements. But financial statements themselves suffer from certain limitations, hence the limitations of financial statements are also the limitations of their analysis. For example, (*a*) sometimes the information given in financial statements are incomplete and not authentic, (*b*) financial Statements are based on accounting concepts and conventions. As such, the utility of financial analysis is decreased due to the shortcomings of financial statements.

(ii) Affected by Window-dressing : Some firms resort to window-dressing their financial statements to cover up bad financial position on the eve of accounting date. For example, they may not record the purchases made at the end of the year or they may overvalue their closing stock. In such cases, the results obtained by analysis of financial statements will be misleading.

(iii) Different Accounting Policies : If two firms adopt different accounting policies, the comparison between the two will be unreliable. For example, one firm may provide depreciation on original cost method, whereas the other firm may adopt the written-down value method for providing the depreciation. Similarly, the method of valuation of closing stock may also differ from one firm to another. The results obtained from the comparison of the financial statements of such firms may give misleading picture.

(iv) Difficulty in Forecasting : Financial statements are a record of past events and historical facts. In the fast changing and developing modern business, the analysis of past information may not be of much use in future forecasting. Continuous changes take place in the demand of the product, policies adopted by the firm, the position of competition etc. As such, no estimate based on the analysis of historical facts can be made for future.

(v) Lack of Qualitative Analysis : Financial statements record only those events and transactions which can be expressed in terms of money. qualitative aspects of business units are omitted from the books at all as these cannot be expressed in monetary terms. Thus, changes in management, reputation of the business, cordial management-labour relations, firm's ability to develop new products, efficiency of management, satisfaction of firm's customers etc. which have a vital bearing on the profitability of the company are all ignored and omitted from being recorded because all of these are qualitative in nature.

(vi) Limited Use of Single Year's Analysis of Financial Statements : Results obtained from financial analysis assume significance only when compared with the figures of previous periods. For example, the profit of a firm to sales is 12%, whether this is satisfactory or not, will depend upon the figures of previous years. If the firm earned 10% of sales as profit in the previous year, it may be considered to have done better this year. However, the financial statements of two years may not be comparable due to the changes in accounting policies.

It is clear from the above mentioned limitations that the results obtained from analysis of financial statements should not be taken as the true indicators of the strength and weaknesses of the concern. The results obtained from analysis must be read carefully and cautiously. The limitations of analysis must be kept in mind while taking decisions based on the results obtained from such analysis.

INTEXT QUESTIONS 31.1

I. Fill in the blanks with suitable word/words :

(i) Financial statements are .... and ....

(ii) The term financial analysis include both .... and ....

(iii) In order to ascertain the financial status of the business every enterprise prepares .... statements.

(iv) Financial statements are mainly prepared for .... purposes.

II. Two columns are given below. Column I lists the parties interested in analysis and column II states the subject of their interest. Match the two columns.

Column I	Column II
(i) Management	(a) about solvency of the business
(ii) Employees	(b) Profitability
(iii) Shareholders	(c) Performance of the enterprise as a whole
(iv) Suppliers and creditors	(d) Better remunerations

III. State whether the following statements are true or false :

(i) If two firms adopt different accounting policies, the comparison between the two will be unreliable.

(ii) Figures given in the financial statements do not speak by themselves.

(iii) Financial statements are records of past events and historical facts.

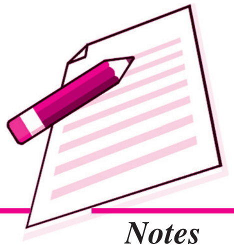
31.3 TECHNIQUES AND TOOLS OF FINANCIAL STATEMENT ANALYSIS

Financial statements give complete information about assets, liabilities, equity, reserves, expenses and profit & loss of an enterprise. They are not readily understandable to interested parties like creditors, shareholders, investors etc. Thus, various techniques are used for analysing and interpreting the financial statements. Techniques of analysis of financial statements are mainly classified into three categories :

(i) Cross-sectional Analysis : It is also known as inter firm comparison. This analysis helps in analysing financial characteristics of an enterprise with financial characteristics of another similar enterprise in that accounting period. For example, if company A has earned 15% profit on capital invested. This does not say whether it is adequate or not. If we analyse further and find that a similar company has earned 16% during the same period, then only we can make a conclusion that company B is better than company A. Thus, it turns into a meaningful analysis.

(ii) Time Series Analysis : It is also called as intra-firm comparison. According to this method, the relationship between different items of financial statements is established, comparisons are made and results obtained. The basis of comparison may be :

- Comparison of the financial statements of different years of the same business unit.



- Comparison of financial statements of a particular year of different business units.

(iii) Cross-sectional cum Time Series Analysis : This analysis is intended to compare the financial characteristics of two or more enterprises for a defined accounting period. It is possible to extend such a comparison over the year. This approach is most effective in analysing of financial statements.

The analysis and interpretation of financial statements is used to determine the financial positon. A number of tools or methods or devices are used to study the relationship between financial statements. However, the following are the important tools which are commonly used for analysing and interpreting financial statements :

- Comparative financial statements
- Common size statements
- Trend analysis
- Ratio analysis
- Funds flow analysis
- Cash flow analysis

- **Comparative financial Statements**

In brief, comparative study of financial statements is the comparison of the financial statements of the business with the previous year's financial statements. It enables identification of weakpoints and applying corrective measures. Practically, two financial statements (balance sheet and income statement) are prepared in comparative form for analysis purposes.

1. Comparative Balance Sheet : The comparative balance sheet shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another. The comparative balance sheet has two columns for the data of original balance sheets. A third column is used to show change (increase/decrease) in figures. The fourth column may be added for giving percentages of increase or decrease. While interpreting comparative Balance sheet the interpreter is expected to study the following aspects :

(i) Current financial position and Liquidity position

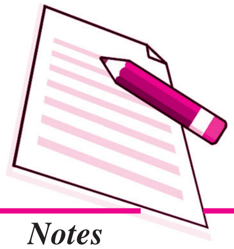
(ii) Long-term financial position

(iii) Profitability of the concern

(i) For studying current financial position or liquidity position of a concern one should examine the working capital in both the years. Working capital is the excess of current assets over current liabilities.

(ii) For studying the long-term financial position of the concern, one should examine the changes in fixed assets, long-term liabilities and capital.

(iii) The next aspect to be studied in a comparative balance sheet is the profitability of the concern. The study of increase or decrease in profit will help the interpreter to observe whether the profitability has improved or not.



Notes

After studying various assets and liabilities, an opinion should be formed about the financial position of the concern.

Format of Comparative Balance Sheet

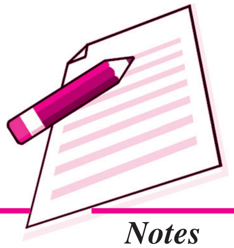
Comparative Balance Sheet

as at ....

Particulars	*Note No.*	*Previous Year ₹ (A)*	*Current Year ₹ (B)*	*Absolute Change (Increase/Decrease) ₹ (C = B - A)*	*Percentage Change (Increase/Decrease) ₹ (D = C/A X 100)*
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
(a) Share Capital:					
(i) Equity Share Capital		...	...	...	...
(ii) Preference Share Capital		...	...	...	...
(b) Reserves and Surplus		...	...	...	...
2. Non-Current Liabilities					
(a) Long-term Borrowings		...	...	...	...
(b) Long-term Provisions		...	...	...	...
3. Current Liabilities					
(a) Short-term Borrowings		...	...	...	...
(b) Trade Payables		...	...	...	...
(c) Other Current Liabilities		...	...	...	...
(d) Short-term Provisions		...	...	...	...
Total		...	...	...	...
II. ASSETS					
1. Non-Current Assets					
(a) Fixed Assets:					
(i) Tangible Assets		...	...	...	...
(ii) Intangible Assets		...	...	...	...
(b) Non-current Investments		...	...	...	...
(c) Long-term Loans and Advances		...	...	...	...
2. Current Assets					
(a) Current Investments		...	...	...	...
(b) Inventories		...	...	...	...
(c) Trade Receivables		...	...	...	...
(d) Cash and Cash Equivalents		...	...	...	...
(e) Short-term Loans and Advances		...	...	...	...
(f) Other Current Assets		...	...	...	...
Total		...	...	...	...

Illustration : 8

From the following Balance Sheets of Exe Ltd. as at 31st March, 2014 and 2013, prepare a Comparative Balance Sheet :



Balance Sheets
as at 31st March, 2014 and 2013

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
Share Capital (Equity)		18,00,000	12,00,000
2. Non-Current Liabilities			
Long-term Borrowings: 8% Debentures (Secured)		6,00,000	6,00,000
3. Current Liabilities			
Trade Payables		6,00,000	3,00,000
Total		**30,00,000**	**21,00,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets : Tangible Assets		18,00,000	15,00,000
2. Current Assets			
(a) Trade Receivables		10,00,000	5,00,000
(b) Cash and Cash Equivalents		2,00,000	1,00,000
Total		**30,00,000**	**21,00,000**

Solution :

Exe Ltd.
Comparative Balance Sheet
as at 31st March, 2013 and 2014

Particulars	*Note No.*	*31st March, 2013 ₹ (A)*	*31st March, 2014 ₹ (B)*	*Absolute Change (Increase/Decrease) ₹ (C = B - A)*	*Percentage Change (Increase/Decrease) % (D = C/A x 100)*
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
Share Capital :					
Equity Share Capital		12,00,000	18,00,000	6,00,000	50.00
2. Non-Current Liabilities					
Long-term Borrowings :					
Secured Loans - 8% Debentures		6,00,000	6,00,000	.....	.....
3. Current Liabilities					
Trade Payables		3,00,000	6,00,000	3,00,000	100.00
Total		**21,00,000**	**30,00,000**	**9,00,000**	**42.86**
II. ASSETS					
1. Non-Current Assets					
Fixed Assets (Tangible)		15,00,000	18,00,000	3,00,000	20.00
2. Current Assets					
(a) Trade Receivables		5,00,000	10,00,000	5,00,000	100.00
(b) Cash and Cash Equivalents		1,00,000	2,00,000	1,00,000	100.00
Total		**21,00,000**	**30,00,000**	**9,00,000**	**42.86**

Illustration : 9

Prepare Comparative Balance Sheet of *XY* Ltd. :

Particulars	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES		
1. Shareholders' Funds		
(*a*) *Share Capital :* Equity Share Capital	3,60,000	3,00,000
(*b*) *Reserves and Surplus*	1,50,000	1,20,000
2. Non-Current Liabilities		
Long-term Borrowings	2,55,000	1,70,000
3. Current Liabilities		
Trade Payables	1,20,000	1,50,000
Total	**8,85,000**	**7,40,000**
II. ASSETS		
1. Non-Current Assets		
Fixed Assets :		
(*i*) Tangible Assets	6,50,000	5,00,000
(*ii*) Intangible Assets	1,00,000	1,00,000
2. Current Assets		
(a) Trade Receivables	1,25,000	1,20,000
(b) Cash and Cash Equivalents	10,000	20,000
Total	**8,85,000**	**7,74,000**

Solution :

Comparative Balance Sheet of *XY* Ltd.

as at 31st March, 2013 and 2014

Particulars	*Note No.*	*31st March, 2013 ₹ (A)*	*31st March, 2014 ₹ (B)*	*Absolute Change (Increase/Decrease) ₹ (C = B - A)*	*Percentage Change (Increase/Decrease) % (D = C/A x 100)*
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
(*a*) *Share Capital :* Equity Share Capital		3,00,000	3,60,000	60,000	20.00
(*b*) Reserves and Surplus		1,20,000	1,50,000	30,000	25.00
2. Non-Current Liabilities					
Long-term Borrowings		1,70,000	2,55,000	85,000	50.00
3. Current Liabilities					
Trade Payables		1,50,000	1,20,000	(30,000)	(20.00)
Total		**7,40,000**	**8,85,00**	**1,45,000**	**19.60**
II. ASSETS					
1. Non-Current Assets					
Fixed Assets :					
(i) Tangible Assets		5,00,000	6,50,000	1,50,000	30.00
(ii) Intangible Assets		1,00,000	1,00,000	.....	.....
2. Current Assets					
(a) Trade Receivables		1,20,000	1,25,000	5,000	4.17
(b) Cash and Cash Equivalents		20,000	10,000	(10,000)	(50.00)
Total		**7,40,000**	**8,85,000**	**1,45,000**	**19.60**

Notes

Comparative Income statement or Comparative Statement of Profit & Loss

The income statement provides the results of the operations of a business. This statement traditionally is known as trading and profit and loss A/c. Important components of income statement are net sales, cost of goods sold, selling expenses, office expenses etc. The figures of the above components are matched with their corresponding figures of previous years individually and changes are noted. The comparative income statement gives an idea of the progress of a business over a period of time. The changes in money value and percentage can be determined to analyse the profitability of the business. Like comparative balance sheet, income statement also has four columns. The first two columns shows figures of various items for two years. Third and fourth columns are used to show increase or decrease in figures in absolute amount and percentages respectively.

The analysis and interpretation of income statement will involve the following :

- The increase or decrease in sales should be compared with the increase or decrease in cost of goods sold.
- To study the operating profits
- The increase or decrease in net profit is calculated that will give an idea about the overall profitability of the concern.

Format of Comparative Statement of Profit & Loss

COMPARATIVE STATEMENT OF PROFIT AND LOSS

for the year ended 31st March, 2013 and 2014

Particulars	*Note No.*	*31st March, 2013* ₹	*31st March, 2014* ₹	*Absolute Change (Increase/Decrease)* ₹	*Percentage Change (Increase/Decrease)* %
I. Revenue from Operations		....	....	....	....
II. Other Income		....	....	....	....
III. **Total Revenue (I + II)**		....	....	....	....
IV. Expenses					
(a) Cost of Materials Consumed		....	....	....	....
(b) Purchases of Stock-in-Trade		....	....	....	....
(c) Change in Inventories of Finsished Goods, Work-in-Progress and Stock-in-Trade		....	....	....	....
(d) Employees Benefit Expenses		....	....	....	....
(e) Finance Costs		....	....	....	....
(f) Depreciation and Amortisation Expenses		....	....	....	....
(g) Other Expenses		....	....	....	....
Total		....	....	....	....
V. ***Profit before Tax (III - IV)***		....	....	....	....
Less : Income Tax		....	....	....	....
VI. **Profit after Tax**		....	....	....	....

Notes

Illustration 10 :

Prepare Comparative Statement of Profit and Loss from the following :

Particulars	*Note No.*	*31st March, 2012 (₹)*	*31st March, 2011 (₹)*
Revenue from Operations		15,00,000	10,00,000
Expenses		10,50,000	6,00,000
Other Income		1,80,000	2,00,000

Solution :

Comparative Statement of Profit and Loss

for the years ended 31st March, 2011 and 2012

Particulars	*Note No.*	*31st March, 2011 ₹ (A)*	*31st March, 2012 ₹ (B)*	*Absolute Change (Increase/Decrease) ₹ (C = B - A)*	*Percentage Change (Increase/Decrease) % (D = C/A x 100)*
I. Revenue from Operations		10,00,000	15,00,000	5,00,000	50.00
II. Other Income		2,00,000	1,80,000	(20,000)	(10.00)
III. **Total Revenue (I + II)**		12,00,000	16,80,000	4,80,000	40.00
IV. *Less:* Expenses		6,00,000	10,50,000	4,50,000	75.00
V. **Profit before Tax (III - IV)**		6,00,000	6,30,000	30,000	5.00

Illustration 11 :

From the following statement of Profit and Loss of Star Ltd. for the years ended 31st March, 2011 and 2012, Prepare a Comparative Statement of Profit and Loss :

Particulars	*Note No.*	*31st March, 2012 (₹)*	*31st March, 2011 (₹)*
Revenue from Operations		20,00,000	16,00,000
Employees Benefit Expenses		10,00,000	8,00,000
Other Expenses		1,00,000	2,00,000

Solution :

Comparative Statement of Profit and Loss

for the years ended 31st March, 2011 and 2012

Particulars	*Note No.*	*31st March, 2011 ₹ (A)*	*31st March, 2012 ₹ (B)*	*Absolute Change (Increase/Decrease) ₹ (C = B - A)*	*Percentage Change (Increase/Decrease) % (D = C/A x 100)*
I. Revenue from Operations		16,00,000	20,00,000	4,00,000	25.00
II. *Less :* Expenses					
(a) Employees Benefit Expenses		8,00,000	10,00,000	2,00,000	25.00
(b) Other Expenses		2,00,000	1,00,000	(1,00,000)	(50.00)
Total Expenses		10,00,000	11,00,000	1,00,000	10.00
III. **Profit before Tax (I - II)**		6,00,000	9,00,000	3,00,000	50.00

Illustration 12 :

Following information is extracted from the Statement of Profit and Loss of Gold Star Ltd., for the years ended 31st March, 2014 and 2013. Prepare Comparative Statement of Profit and Loss.

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
Revenue from Operations		40,00,000	32,00,000
Employees Benefit Expenses		20,00,000	16,00,000
Depreciation and Amortisation Expenses		50,000	40,000
Other Expenses		1,50,000	3,60,000
Tax Rate 30%			

Solution :

Comparative Statement of Profit and Loss
for the years ended 31st March, 2013 and 2014

Particulars	*Note No.*	*31st March, 2013 ₹ (A)*	*31st March, 2014 ₹ (B)*	*Absolute Change (Increase/Decrease) ₹ (C = B - A)*	*Percentage Change (Increase/Decrease) % (D = C/A x 100)*
I. Revenue from Operations		32,00,000	40,00,000	8,00,000	25.00
II. **Expenses**					
(a) Employees Benefit Expenses		16,00,000	20,00,000	4,00,000	25.00
(b) Depreciation and Amortisation Expenses		40,000	50,000	10,000	25.00
(c) Other Expenses		3,60,000	1,50,000	(2,10,000)	(58.33)
Total xpenses		**20,00,000**	**22,00,000**	**2,00,000**	**10.00**
III. **Profit before Tax (I - II)**		**12,00,000**	**18,00,000**	**6,00,000**	**50.00**
Less : Tax @ 30%		3,60,000	5,40,000	1,80,000	50.00
IV. **Profit after Tax**		**8,40,000**	**12,60,000**	**4,20,000**	**50.00**

Illustration 13 :

Prepare Comparative Statement of Profit and Loss from the following :

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
Revenue from Operations		8,00,000	4,20,000
Purchases of Stock-in-Trade		4,50,000	2,50,000
Change in Inventories of Stock-in-Trade		50,000	50,000
Other Expenses (% of Cost of Goods Sold)		8%	10%
Tax		30%	30%

Solution :

Comparative Statement of Profit and Loss
for the years ended 31st March, 2013 and 2014

Particulars	*Note No.*	*31st March, 2013 ₹ (A)*	*31st March, 2014 ₹ (B)*	*Absolute Change (Increase/Decrease) ₹ (C = B - A)*	*Percentage Change (Increase/Decrease) % (D = C/A x 100)*
I. Revenue from Operations (Sales)		4,20,000	8,00,000	3,80,000	90.47
II. **Expenses**					
(a) Purchases of Stock-in-Trade		2,50,000	4,50,000	2,00,000	80.00
(b) Change in Inventories of Stock-in-Trade		50,000	50,000	.....	.....
(c) Other Expenses		30,000	40,000	10,000	33.33
Total Expenses		**3,30,000**	**5,40,000**	**2,10,000**	**63.64**
III. **Profit before tax (I - II)**		**90,000**	**2,60,000**	**1,70,000**	**188.89**
Less: Tax		27,000	78,000	51,000	188.89
IV. **Profit after Tax**		63,000	1,82,000	1,19,000	188.89

Note : Cost of Goods Sold = Purchases + Change in Inventories.

INTEXT QUESTIONS 31.2

Fill in the blanks with appropriate word/words :

(i) Time series analysis is a technique of ....

(ii) Comparative statement is a .... for financial statement analysis.

(iii) .... is the comparison of the financial statements of business with the previous years financial statements.

(iv) Comparative .... shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another.

(v) .... income statement gives an idea of the progress of a business over a period of time.

31.4 COMMON SIZE STATEMENTS AND TREND ANALYSIS

The common size statements (Balance Sheet and Income Statement) are shown in analytical percentages. The figures of these statements are shown as percentages of total assets, total liabilities and total sales respectively. Take the example of Balance Sheet. The total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities.

Common Size Balance Sheet

A statement where balance sheet items are expressed in the ratio of each asset to total assets and the ratio of each liability is expressed in the ratio of total liabilities is called common size balance sheet.

Thus the common size statement may be prepared in the following way.

- The total assets or liabilities are taken as 100
- The individual assets are expressed as a percentage of total assets i.e. 100 and different liabilities are calculated in relation to total liabilities.

For example, if total assets are ₹10 lakhs and value of inventory is ₹ 1,00,000, then inventory will be 10% of total assets $\left(\frac{1,00,000\times100}{10,00,000}\right)$

Format of Common-size Balance Sheet

COMMON-SIZE BALANCE SHEET

as at 31st March, 2013 and 2014

Particulars	*Note No.*	*Absolute Amounts*		*Percentage of Balance Sheet Total*	
		31st March, 2013 (₹)	*31st March, 2014 (₹)*	*31st March, 2013 (%)*	*31st March, 2014 (%)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
(a) *Share Capital:*					
(i) Equity Share Capital		....	....	....	....
(ii) Preference Share Capital		....	....	....	....
(b) Reserves and Surplus		....	....	....	....
2. Non-Current Liabilities					
(a) Long-term Borrowings		....	....	....	....
(b) Long-term Provisions		....	....	....	....
3. Current Liabilities					
(a) Short-term Borrowings		....	....	....	....
(b) Trade Payables		....	....	....	....
(c) Other Current Liabilities		....	....	....	....
(d) Short-term Provisions		....	....	....	....
Total		....	....	100	100
II. ASSETS					
1. Non-Current Assets					
(a) *Fixed Assets:*					
(i) Tangible Assets		....	....	....	....
(ii) Intangible Assets		....	....	....	....
(b) Non-Current Investments		....	....	....	....
(c) Long-term Loans and Advances		....	....	....	....
2. Current Assets					
(a) Current investments		....	....	....	....
(b) Inventories		....	....	....	....
(c) Trade Receivables		....	....	....	....
(d) Cash and Cash Equivalents		....	....	....	....
(e) Short-term Loans and Advances		....	....	....	....
(f) Other Current Assets		....	....	....	....
Total		....	....	100	100

Illustration 14

From the following Balance Sheets of *XYZ* Ltd. as at 31st March, 2014 and 2013, prepare a Common-size Balance Sheet.

Balance Sheets
as at 31st March, 2014 and 2013

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital		10,00,000	5,00,000
(b) Reserves and Surplus		2,00,000	3,00,000
2. Non-Current Liabilities			
Long-term Borrowings		8,00,000	5,00,000
3. Current Liabilities			
Trade Payables		4,00,000	2,00,000
Total		**24,00,000**	**15,00,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets - Tangible Assets		15,00,000	10,00,000
2. Current Assets			
Cash and Cash Equivalents		9,00,000	5,00,000
Total		**24,00,000**	**15,00,000**

Solution :

Common-size Balance Sheet of *XYZ* Ltd.
as at 31st March, 2013 and 2014

Particulars	*Note No.*	*Absolute Amounts*		*Percentage of Balance Sheet Total*	
		31st March, 2013 (₹)	*31st March, 2014 (₹)*	*31st March, 2013 (%)*	*31st March, 2014 (%)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
(a) Share Capital		5,00,000	10,00,000	33.33	41.67
(b) Reserves and Surplus		3,00,000	2,00,000	20.00	8.33
2. Non-Current Liabilities					
Long-term Borrowings		5,00,000	8,00,000	33.34	33.33
3. Current Liabilities					
Trade Payables		2,00,000	4,00,000	13.33	16.67
Total		15,00,000	24,00,000	100.00	100.00

II. ASSETS					
1. Non-Current Assets					
Fixed Assets - Tangible Assets		10,00,000	15,00,000	66.67	62.50
2. Current Assets					
Cash and Cash Equivalents		5,00,000	9,00,000	33.33	37.50
Total		**15,00,000**	**24,00,000**	**100.00**	**100.00**

Note : % is calculated on the basis of total of equity and liabilities/total assets

$$\% \text{ of Share Capital (31st March, 2013)} = \frac{5,00,000}{15,00,000} \times 100 = 33.33\%$$

In the same manner, other percentages may be calculated.

Illustration 15

From the following Balance Sheets of Sun Ltd., as at 31st March, 2014 and 2013, prepare Common-Size Balance Sheet.

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital		80,00,000	60,00,000
(b) Reserves and Surplus		12,00,000	8,00,000
2. Non-Current Liabilities			
Long-term Borrowings		24,00,000	20,00,000
3. Current Liabilities			
Short-term Borrowings		4,00,000	12,00,000
Total		**1,20,00,000**	**1,00,00,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets :			
(i) Tangible Assets		80,00,000	60,00,000
(ii) Intangible Assets		4,00,000	12,00,000
2. Current Assets			
(a) Inventories		24,00,000	20,00,000
(b) Cash and Cash Equivalents		12,00,000	8,00,000
Total		**1,20,00,000**	**1,00,00,000**

Notes

Solution :

Common-size Balance Sheet of Sun Ltd.
as at 31st March, 2013 and 2014

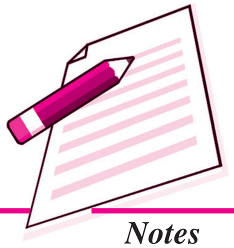
Particulars	*Note No.*	*Absolute Amounts*		*Percentage of Balance Sheet Total*	
		31st March, 2013 (₹)	*31st March, 2014 (₹)*	*31st March, 2013 (%)*	*31st March, 2014 (%)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
(a) Share Capital		60,00,000	80,00,000	60.00	66.70
(b) Reserves and Surplus		8,00,000	12,00,000	8.00	10.00
2. Non-Current Liabilities					
Long-term Borrowings		20,00,000	24,00,000	20.00	20.00
3. Current Liabilities					
Short-term Borrowings		12,00,000	4,00,000	12.00	3.30
Total		**10,00,000**	**1,20,00,000**	**100.00**	**100.00**
II. ASSETS					
1. Non-Current Assets					
Fixed Asset:					
(i) Tangible Assets		60,00,000	80,00,000	60.00	66.70
(ii) Intangible Assets		12,00,000	4,00,000	12.00	3.30
2. Current Assets					
(a) Inventories		20,00,000	24,00,000	20.00	20.00
(b) Cash and Cash Equivalents		8,00,000	12,00,000	8.00	10.00
Total		**1,00,00,000**	**1,20,00,000**	**100.00**	**100.00**

Common Size Income Statement

The items in income statement can be shown as percentages of sales to show the relations of each item to sales.

Format of Common Size Statement of Profit and Loss (Income Statement)

Particulars	*Note No.*	*Absolute Amounts*		*Percentage of Revenue from Operations (Net Sales)*	
		2013 (₹)	*2014 (₹)*	*2013 (%)*	*2014 (%)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
I. Revenue from Operations (Net Sales)		....	....	....	....
II. Other Income		....	....	....	....
III. **Total Revenue (I + II)**		....	....	....	....
IV. **Expenses**					
(a) Cost of Materials Consumed		....	....	....	....
(b) Purchases of Stock-in-Trade		....	....	....	....
(c) Change in Inventories of					



Notes

	Finished Goods, Work-in-Progress and Stock-in-Trade		....	....	....	....
	(d) Employees Benefit Expenses		....	....	....	....
	(e) Finance Costs		....	....	....	....
	(f) Depreciation and Amortisation Expenses		....	....	....	....
	(g) Other Expenses		....	....	....	....
	Total Expenses		....	....	....	....
V.	**Profit before Tax (III - IV)**		....	....	....	....
VI.	*Less:* Income Tax		....	....	....	....
VII.	**Profit after Tax (V - VI)**		....	....	....	....

Illustration : 16

From the following Statement of Profit and Loss of Star Ltd. for the years ended 31st March, 2014 and 2013, prepare a Common-size Statement of Profit and Loss:

Particulars	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
Revenue from Operations	20,00,000	16,00,000
Employees Benefit Expenses	10,00,000	8,00,000
Other Expenses	1,00,000	2,00,000

Solution :

Common-size Statement of Profit and Loss

for the years ended 31st March, 2013 and 2014

Particulars	*Note No.*	*Absolute Amounts*		*Percentage of Revenue from Operations (Net Sales)*	
		2013 (₹)	*2014 (₹)*	*2013 (%)*	*2014 (%)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
I. Revenue from Operations		16,00,000	20,00,000	100.00	100.00
II. Employees Benefit Expenses		8,00,000	10,00,000	50.00	50.00
Other Expenses		2,00,000	1,00,000	12.50	5.50
III. Total Expenses		10,00,000	11,00,000	62.50	55.00
IV. **Profit before Tax (I - III)**		**6,00,000**	**9,00,000**	**37.50**	**45.00**

Illustration : 17

From the following Statement of Profit and Loss, prepare Common-size Statement of Profit and Loss and give comments.

Notes

Particulars	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. **Income**		
Revenue from Operations (Net Sales)	12,50,000	10,00,000
II. **Expenses**		
Purchases of Stock-in-Trade	8,70,000	7,20,000
Change in Inventories of Stock-in-Trade	(20,000)	30,000
Depreciation and Amortisation Expenses	30,000	20,000
Other Expenses	50,000	30,000
Total	**9,30,000**	**8,00,000**
III. **Profit before Tax (I - II)**	**3,20,000**	**2,00,000**
IV. *Less:* Income Tax	96,000	60,000
V. **Profit after Tax (III - IV)**	**2,24,000**	**1,40,000**

Solution :

Common-size Statement of Profit and Loss
for the years ended 31st March, 2013 and 2014

Particulars	*Note No.*	*Absolute Amounts*		*Percentage of Revenue from Operations (Net Sales)*	
		2013 (₹)	*2014 (₹)*	*2013 (%)*	*2014 (%)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
I. Revenue from Operations (Net Sales)		10,00,000	12,50,000	100.00	100.00
II. **Expenses**					
(a) Purchases of Stock-in-Trade		7,20,000	8,70,000	72.00	69.60
(b) Change in Inventories of Stock-in-Trade		30,000	(20,000)	3.00	(1.60)
(c) Depreciation and Amortisation Expenses		20,000	30,000	2.00	2.40
(d) Other Expenses		30,000	50,000	3.00	4.00
III. **Total Expenses**		**8,00,000**	**9,30,000**	**80.00**	**74.40**
IV. **Profit before Tax (I - II)**		**2,00,000**	**3,20,000**	**20.00**	**25.60**
V. *Less :* Income Tax		60,000	96,000	6.00	7.68
VI. **Profit after Tax (III - IV)**		**1,40,000**	**2,24,000**	**14.00**	**17.92**

Comments :

1. Purchases of Stock-in-Trade and Change in Inventories of Stock-in-Trade have decreased from 75% to 68%. There are two possible reasons for this change :
   i. Efficient functioning of the purchase and production department.
   ii. Increase in the sale price of the product without corresponding increase in the cost of inputs.
2. Increase in net profit is mainly due to decrease in the percentage of Cost of Goods Sold.

INTEXT QUESTIONS 31.3

Fill in the blanks with appropritate word/words

(i) .... statement shows analytical percentage. (comparative, common size)

(ii) .... balance sheet items are expressed in the ratio of each asset to total assets and ratio of each liability to total liabilities. (comparative, common size)

(iii) .... analysis is a technique of studying several financial statements over a series of years. (Trend, time series)

(iv) Trend percentage is calculated on the basis of .... year. (current, base)

WHAT YOU HAVE LEARNT

- Analysis of financial statements means establishing meaningful, relationship between various items of the two financial statements i.e. income statement and position statement.
- Limitations of Financial Analysis
  - (i) Affected by window dressing
  - (ii) Do not reflect changes in price level.
  - (iii) Different Accounting policies.
  - (iv) Difficulty in forecasting.
  - (v) Limitations of financial statements.
- The main parties interested in analysis of financial statements are

(i)	Investors	(ii)	Management
(iii)	Trade unions	(iv)	Lenders
(v)	Trade creditors	(vi)	Employees
(vii)	Tax authorities	(viii)	Government
(ix)	Stock exchange	(x)	Researchers

- The major techniques of financial statement analysis are
  - (i) Cross-sectional analysis
  - (ii) Time series analysis
  - (iii) Cross-sectional and time series analysis.

- The major tools for financial statement analysis are :

  (i) comparative statement (ii) Common size statement
  (iii) Ratio analysis (iv) Funds flow analysis
  (v) cash flow analysis

- Comparative study of financial statements is the comparison of the financial statements of the business with the previous years financial statements.

- Comparative Balance Sheet shows the different assets and liabilites of the firm on different dates to make comparison of balances from one date to another.

- Common size balance sheet items are expressed in the ratio of each asset to total assets and the ratio of each liability is expressed in the ratio of total liablities.

TERMINAL EXERCISE

1. State any four tools which are commonly used for analysing and interpreting financial statements.
2. What are the main limitations of financial Analysis? Explain in detail.
3. How do limitations of financial statements became limitation of analysis of financial statements.
4. State any three limitations of analysis of financial statements.
5. Briefly explain the limitations of analysis of financial statements.
6. What are the main techniques of financial statement analysis?
7. Briefly explain the parties interested in analysis of financial statements.
8. Write a brief note on comparative statement, common size statement and trend analysis.
9. Following are the Balance Sheets of Radha Ltd. as at 31st March, 2014 and 2013 :

Particulars	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES		
1. Shareholders' Funds		
(a) Share Capital	15,00,000	10,00,000
(b) Reserves and Surplus	10,00,000	10,00,000
2. Non-Current Liabilities		
Long-term Borrowings	8,00,000	2,00,000
3. Current Liabilities		
Trade Payables	5,00,000	3,00,000
Total	**38,00,000**	**25,00,000**

II. ASSETS		
1. Non-Current Assets		
Fixed Assets :		
(i) Tangible Assets	25,00,000	15,00,000
(ii) Intangible Assets	5,00,000	5,00,000
2. Current Assets		
(a) Trade Receivables	6,00,000	3,50,000
(b) Cash and Cash Equivalents	2,00,000	1,50,000
Total	**38,00,000**	**25,00,000**

You are required to prepare Comparative Balance Sheet on the basis of the information given in the above Balance Sheets.

10. Prepare Comparative Balance Sheet of Deepankur Ltd.:

Particulars	*March 31, 2014 (₹)*	*March 31, 2013 (₹)*
I. EQUITY AND LIABILITIES		
1. Shareholders' Funds		
(a) Share Capital	9,00,000	7,50,000
(b) Reserves and Surplus	3,30,000	2,85,000
2. Non-Current Liabilities		
Long-term Borrowings:		
12% Debentures, Secured	3,00,000	4,50,000
3. Current Liabilities		
(a) Short-term Borrowings	1,40,000	1,70,000
(b) Trade Payables	2,00,000	1,50,000
(c) Other Current Liabilities	60,000	45,000
(d) Short-term Provisions	20,000	10,000
Total	**19,50,000**	**18,60,000**
II. ASSETS		
1. Non-Current Assets		
(a) Fixed Assets	9,55,000	10,45,000
(b) Non-Current Investments	2,00,000	2,00,000
2. Current Assets		
(a) Inventories	2,50,000	2,00,000
(b) Trade Receivables	2,50,000	2,25,000
(c) Cash and Cash Equivalents	1,95,000	1,10,000
(d) Other Current Assets	1,00,000	80,000
Total	**19,50,000**	**18,60,000**

11. From the following Statement of Profit and Loss, prepare Comparative Statement of Profit and Loss (Income Statement) :

Particulars	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. Income		
Revenue from Operations (Sales)	19,20,000	16,00,000
II. Expenses		
Purchases of Stock-in-Trade	11,70,000	9,50,000
Change in Inventories of Stock-in-Trade	(10,000)	50,000
Employees Benefit Expenses	3,80,000	2,80,000
Other Expenses	1,50,000	2,00,000
Total	**16,90,000**	**14,80,000**
III. Net Profit (I - II)	**2,30,000**	**1,20,000**

12. From the following information taken from the Statement of Profit and Loss of Star Products Ltd. for the years ended 31st March, 2014 and 2013, prepare Comparative Statement of Profit and Loss:

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2014 (₹)*
Revenue from Operations		50,00,000	40,00,000
Employees Benefit Expenses		13,10,000	12,00,000
Other Expenses		15,00,000	13,00,000
Tax Rate (30%)			

ANSWERS TO INTEXT QUESTIONS

31.1 I. (i) Statement of Profit and Loss, Balance Sheet.
(ii) analysis, interpretation
(iii) financial
(iv) decision making

II. (i) (c) (ii) (d) (iii) (b) (iv) (a)

III. (i) True (ii) True (iii) True

31.2 (i) financial statement analysis (ii) tool
(iii) comparative statement (iv) balance sheet
(v) comparative

31.3 (i) Comparative (ii) Comparative (iii) Trend (iv) base

32

ACCOUNTING RATIOS - I

In the previous lesson, you have learnt the relationship between various items of the financial statements. You have also learnt various tools of analysis of financial statements such as comparative statements, common size statement, and trend analysis. However, like the above tools another important tool which is very useful to examine the financial statements is ratio analysis. Accounting ratios are calculated from the financial statements to arrive at meaningful conclusions pertaining to liquidity, profitability, and solvency. Accounting ratios can be of different types. In this lesson, we will learn about different types of accounting ratios and their methods of calculation.

OBJECTIVES

After studying this lesson, you will be able to :

- state the meaning of accounting ratio;
- classify the accounting ratios;
- explain various types of accounting ratios on the basis of liquidity and turnover.

32.1 OBJECTIVES OF RATIO ANALYSIS

Ratios are regarded as a test of earning capacity, financial soundness and operating efficiency of a business organisation. The use of ratios in accounting and financial management analysis helps the management to know the profitability, financial position (liquidity and solvency) and operating efficiency of an enterprises.

The objectives of ratio analysis may be better understood by the following advantages of ratio analysis.

Advantages and Uses of Ratio Analysis

The advantages derived by an enterprise by the use of accounting ratios are:

i. **Useful in Analysis of Financial Statements :** Accounting ratios are useful for understanding the financial position of the enterprise. Bankers, investors, creditors, etc., all analyse Balance Sheets and Profit and Loss Accounts by means of ratios.

ii. **Useful in Simplifying Accounting Figures :** Accounting ratio simplifies, summarises and systematises a long array of accounting figures to make them understandable. Its main contribution lies in communicating precisely the inter-relationships which exist between various elements of financial statements.

iii. **Useful in Judging the Operating Efficiency of Business :** Accounting ratios are essential for understanding the affairs of an enterprise, specially its operating efficiency. Accounting ratios are also useful for diagnosis of the financial health of an enterprise. This is done by evaluating liquidity, solvency, profitability, etc. Such an evaluation enables the management to assess financial requirements and the capabilities of various business units.

iv. **Useful for Forecasting :** Ratios are helpful in business planning and forecasting. The trend ratios are analysed and used as a guide to future planning. What should be the course of action in the immediate future is decided, many a times, on the basis of trend ratios, *i.e.,* ratios calculated for a number of years.

v. **Useful in Locating the Weak Spots :** Accounting ratios are of great assistance in locating the weak spots in the business even though the overall performance may be quite good. Management can pay attention to the weakness and take remedial action. For example, if the firm finds that the increase in distribution expenses is more than proportionate to the results achieved, these can be examined in detail and depth to remove any wastage that may be there.

vi. **Useful in Inter-firm and Intra-firm Comparison :** A firm would like to compare its performance with that of other firms and of industry in general. The comparison is called inter-firm comparison. If the performance of different units belonging to the same firm is to be compared, it is called intra-firm comparison. Such comparison is almost impossible without accounting ratios. Even the progress of a firm from year to year cannot be measured without the help of ratios. The accounting ratios are the best tools to compare the various firms and divisions of a firm.

32.2 MEANING AND ITS CLASSIFICATION

The ratio is an arithmetical expression i.e. relationship of one number to another. It may be defined as an indicated quotient of the mathematical expression. It is expressed as a proportion or a fraction or in percentage or in terms of number of times. A financial ratio is the relationship between two accounting figures expressed mathematically. Suppose two accounting figures of a concern are sales ₹ 1,00,000 and profits ₹ 15,000. The ratio between these two figures will be

$$\frac{15{,}000}{1{,}00{,}000} = 3 : 20 \text{ or } 15\%$$

Ratios provide clues to the financial position of a concern. These are the indicators of financial strength, soundness, position or weakness of an enterprise. One can draw conclusions about the financial position of a concern with the help of accounting ratios.

Suppose one shopkeeper (X) earns a profit of ₹ 1,000 and another (Y) earns ₹ 20,000 which one is more efficient? We may say that the one who earns a higher profit is running his shop better. In fact to answer the questions, we must ask, how much is the capital employed by each shopkeeper? Let, X employ ₹1,00,000 and Y ₹ 4,00,000. We can work out the percentage of profit earned by each to the capital employed. Thus,

$$X = \frac{₹\ 10{,}000}{₹\ 1{,}00{,}000} \times 100 = 10\%$$

$$Y = \frac{₹\ 20{,}000}{₹\ 4{,}00{,}000} \times 100 = 5\%$$

These figures show that for every ₹100 of capital, X earns ₹ 10 and Y earns ₹ 5. X is obviously making a better use of the funds employed by him. He must be treated as more efficient of the two. The above example shows that absolute figures by themselves do not communicate the meaningful information.

Broadly accounting ratios can be grouped into the following categories :

(a) Liquidity ratios (b) Activity ratios (c) Solvency ratios

(c) Profitability ratios

Liquidity Ratios

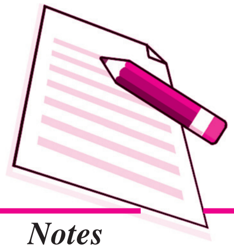
The term liquidity refers to the ability of the company to meet its current liabilities. Liquidity ratios assess capacity of the firm to repay its short term liabilities. Thus, liquidity ratios measure the firms' ability to fulfil short term commitments out of its liquid assets. The important liquidity ratios are :

(i) Current Ratio

(ii) Quick Ratio

(i) Current Ratio : Current ratio is a ratio between current assets and current liabilities of a firm for a particular period. This ratio establishes a relationship between current assets and current liabilities. The objective of computing this ratio is to measure the ability of the firm to meet its short term liability. It compares the current assets and current liabilities of the firm. This ratio is calculated as under :

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$



Notes

Current Assets are those assets which can be converted into cash within a short period i.e. not exceeding one year. It includes the following :

Cash in hand, Cash at Bank,Trade Receivables, Short term investment, Stock, Prepaid expenses.

Trade Receivables include Bills Receivables and Sundry Debtors.

Current liabilities are those liabilities which are expected to be paid within a year. It includes the following :

Trade Payables, Bank overdraft, Provision for tax, Outstanding expenses.

Trade Payables include Sundry Creditors and Bills Payables.

Significance

It indicates the amount of current assets available for repayment of current liabilities. Higher the ratio, the greater is the short term solvency of a firm and vice - versa. However, a very high ratio or very low ratio is a matter of concern. If the ratio is very high it means the current assets are lying idle. Very low ratio means the short term solvency of the firm is not good. Thus, the ideal current ratio of a company is 2 : 1 i.e. to repay current liabilities, there should be twice current assets.

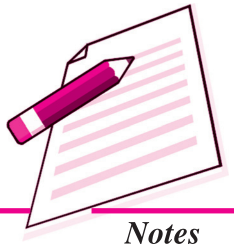
Illustration 1

Calculate current ratio from the following :

	₹
Sundry debtors	4,00,000
Stock	160,000
Marketable securities	80,000
Cash	120,000
Prepaid expenses	40,000
Bill payables	80,000
Sundry creditors	160,000
Debentures	200,000
Outstanding Expenses	160,000

Solution :

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$



Current Assets = Sundry Debtors + Stock + Marketable Securities + Cash + Prepaid Expenses

= ₹ (400,000 + 160,000 + 80,000 + 120,000 + 40,000)

= ₹ 800,000

Current Liabilities = Bill Payables + Sundry Creditors + Outstanding Expenses

= ₹ (80,000 + 160,000 + 160,000) = ₹ 400,000

$$\text{Current Ratio} = \frac{₹\ 8,00,000}{₹\ 4,00,000} = 2:1$$

(ii) Quick Ratio : Quick ratio is also known as Acid test or Liquid ratio. It is another ratio to test the short-term solvency of the concern. This ratio establishes a relationship between quick assets and current liabilities. This ratio measures the ability of the firm to pay its current liabilities. The main purpose of this ratio is to measure the ability of the firm to pay its current liabilities. For the purpose of calculating this ratio, stock and prepaid expenses are not taken into account as these may not be converted into cash in a very short period. This ratio is calculated as under:

$$\text{Liquid Ratio} = \frac{\text{Liquid or Quick Assets}}{\text{Current Liabilities}}$$

where, liquid assets = current assets – (stock + prepaid expenses)

Significance

Quick ratio is a measure of the instant debt paying capacity of the business enterprise. It is a measure of the extent to which liquid resources are immediately available to meet current obligations. A quick ratio of 1 : 1 is considered good/favourable for a company.

Illustration 2

Taking the same information as given in illustrated 1 calculate the quick ratio.

Solution :

$$\text{Quick Ratio} = \frac{\text{Liquid or Quick Assets}}{\text{Current Liabilities}}$$

Quick Assets = Currents Assets – (Stock + Prepaid Expenses)

= ₹ 8,00,000 – (₹ 1,60,000 + ₹ 40,000) = ₹ 6,00,000

Current Liabilities = ₹ 6,00,000

$$\text{Quick Ratio} = \frac{₹\ 6,00,000}{₹\ 6,00,000} = 1:1$$

Illustration 3

Calculate liquidity ratios from the following information :

Total current assets	₹ 90,000
Stock (included in current assets)	₹ 30,000
Prepaid expenses	₹ 3,000
Current liabilities	₹ 60,000

Solution :

A. Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{₹90,000}{₹60,000}$

$= 3 : 2 \text{ or } 1.5 : 1$

B. Liquid ratio $= \dfrac{\text{Current Asset - (Stock + Prepaid Expenses)}}{\text{Current Liabilities}}$

$= \dfrac{₹57,000}{₹60,000} = 0.95 : 1.0$

Illustration 4

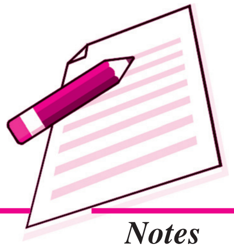
The balance sheet of ABCD Ltd. shows the following figures :

Share capital	₹ 152,000
Cash in hand and at Bank	₹ 30,000
Fixed Assets	₹ 113,000
Creditors	₹ 20,000
5% Debentures	₹ 24,000
Bill Payables	₹ 4,000
Debtors	₹ 18,000
Stock	₹ 52,000
General reserve	₹ 8,000
Profit and Loss A/c	₹ 5,000

Calculate (i) current ratio and (ii) liquid ratio.

Solution :

(i) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$



where,

Current Assets = Cash in hand and at bank + Debtors + Stock

= ₹ 30,000 + ₹ 18,000 + ₹ 52,000

= ₹ 1,00,000

Current Liabilities = Creditors + Bill Payable

= ₹ 20,000 + ₹ 4,000

= ₹ 24,000

$$= \frac{₹\ 1,00,000}{₹\ 24,000} = 4.26 : 1$$

(ii) Quick Ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$

where,

Quick assets = Current Assets – Stock

= ₹ 1,00,000 – ₹ 52,000

= ₹ 48,000

Quick ratio $= \frac{₹48,000}{₹24,000} = 2 : 1$

Illustration 5

From the following information, if ₹ 1000 is paid to creditors what will be the effect (increase or decrease or no change) on current ratio, if before payment, balances are : Cash ₹ 15000, Creditors ₹ 7,500?

Solution :

Current Ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$

Before payment $= \frac{\text{Cash}}{\text{Creditors}} = \frac{₹15,000}{₹7,500} = 2 : 1$

After payment = ₹1000 to creditors

Current Ratio $= \frac{\text{Cash}}{\text{Creditors}} = \frac{₹15,000 - ₹1,000}{₹7,500 - ₹1,000}$

$$= \frac{₹14,000}{₹6,500} = 2.15 : 1$$

Hence, it increases the current ratio from 2 : 1 to 2.15 : 1

INTEXT QUESTIONS 32.1

I. Select the current assets from the list given below

Cash at bank	Debtors
Inventory	Prepaid expenses
Short term investment	Goodwill
Building	Cash in hand
Furniture	
Bill Receivables	

II. Fill in the blanks with suitable words or figures :

(i) Current Ratio = $\dfrac{\text{...........................}}{\text{Current Liabilities}}$

(ii) The ideal current ratio is ....

(iii) The ideal liquid ratio is ....

(iv) Liquid assets = ... – (Stock + prepaid expenses)

III. State whether the following statements are true or false :

(i) Ratios are not helpful in business planning and forecasting.

(ii) Accounting ratios are useful for understanding the financial position of the enterprise.

32.3 ACTIVITY OR TURNOVER RATIOS

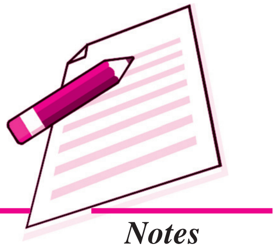
Activity ratios measure the efficiency or effectiveness with which a firm manages its resources. These ratios are also called turnover ratios because they indicate the speed at which assets are converted or turned over in Revenue from operations (sales). These ratios are expressed as ‘times’ and should always be more than one. Some of the important activity ratios are :

(i) Inventory turnover ratio (Stock turnover ratio)

(ii) Trade Receivables turnover ratio (Debtors turnover ratio)

(iii) Trade Paybles turnover ratio (Creditors turnover ratio)

(iv) Working capital turnover ratio



Notes

(i) Inventory Turnover Ratio (Stock Turnover Ratio)

Inventory turnover ratio is a ratio between cost of revenue from operation and the average inventory. Every firm has to maintain a certain level of inventory of finished goods. But the level of inventory should neither be too high nor too low. It evaluates the efficiency with which a firm is able to manage its inventory. This ratio establishes relationship between cost of revenue from operation and average inventory.

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

Cost of Revenue from Operation = Opening Inventory + Net Purchases + Direct expenses – Closing Inventory

OR Cost of Revenue from Operation = Net Sales – Gross Profit

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

(i) If cost of revenue from operation is not given, the ratio is calculated from revenue from operations (sales).

(ii) If only closing inventory is given, then that may be treated as average inventory.

Significance

The ratio signifies the number of times on an average the inventory or stock is disposed off during the period. The high ratio indicates efficiency and the low ratio indicates inefficiency of stock management.

Illustration 6

Calculate inventory turnover ratio from the following information:

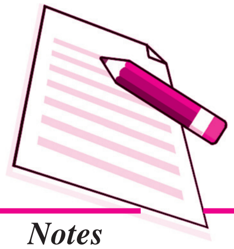
Opening inventory	₹ 45000
Closing inventory	₹ 55000
Net Purchases	₹ 160000

Solution :

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

$$\text{Average Inventory} = \frac{₹(45{,}000 + 55{,}000)}{2}$$



Notes

$= ₹\ 50000$

Cost of Revenue from Operations = Opening Inventory + Net Purchases – Closing Inventory

$= ₹\ 45000 + ₹\ 160000 - ₹\ 55000$

$= ₹\ 150000$

Inventory Turnover Ratio $= \dfrac{₹\ 1,50,000}{₹\ 50,000} = 3$ times

Illustration 7

Opening Inventory	₹	19,000
Closing Inventory	₹	21,000
Revenue from Operations (Sales)	₹	2,00,000

Gross Profit 25% of revenue from operations. Calculate inventory turnover ratio.

Solution :

Cost of Revenue from Operations = Revenue from Operations – Gross profit

$= ₹\ 2,00,000 - 25\%$ of $₹\ 2,00,000$

$= ₹\ (2,00,000 - 50,000)$

$= ₹\ 1,50,000$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

$$= \frac{₹(19,000 + 21,000)}{2}$$

$= ₹\ 20,000$

$$\text{Inventory turn over Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

$$= \frac{₹\ 1,50,000}{₹\ 20,000} = 7.5 \text{ times}$$

Illustration 8

Annual sales	₹ 4,00,000
Gross profit 20% on sales	
Opening Inventory	₹ 38,500
Closing Inventory	₹ 41,500

Calculate inventory turnover ratio.

Solution :

$$\text{Inventory turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

Costs of revenue from Ooperations = Sales – Gross profit

= ₹ 4,00,000 – (20% on ₹ 4,00,000)

= ₹ 4,00,000 – ₹ 80,000

= ₹ 320,000

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

$$= \frac{38,500 + 41,500}{2} = \frac{80,000}{2}$$

= ₹ 40,000

$$\text{Inventory turnover Ratio} = \frac{₹\ 3,20,000}{₹\ 40,000} = 8 \text{ times}$$

Illustration 9

From the following information calculate opening inventory and closing inventory:

Revenue from operations (sales) during the year	=	₹ 2,00,000
Gross profit on sales	=	50%
Inventory turnover ratio	=	4 times

If closing inventory was ₹ 10,000 more than the opening inventory what will be the amount for the opening inventory and closing inventory?

Solution :

Revenue from Operations (Sales) = ₹ 2,00,000 (given)

Gross profit on sales = 50% (given)

Notes

Gross profit = $2,00,000 \times \frac{50}{100} = 1,00,000$

Cost of Revenue from operation = Sales – Gross profit

= ₹ 2,00,000 – ₹ 1,00,000

= ₹1,00,000

Inventory Turnover Ratio = $\frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$

4 = $\frac{1,00,000}{\text{Average Inventory}}$

∴ By cross multiplying

Average Inventory = $\frac{₹1,00,000}{4}$ = ₹ 25,000

Average Inventory = $\frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$

Let opening inventory be x

Closing Inventory = $x + 10,000$

Average Inventory = $\frac{x + x + 10,000}{2}$ = 25,000 (given)

or $x + x + 10,000$ = 50,000

or $2x$ = 50,000 – 10,000

or $2x$ = 40,000

or x = 20,000

Hence, Opening Inventory = ₹ 20,000

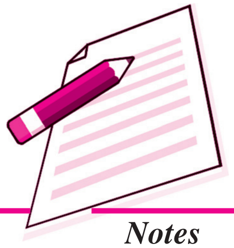
Closing Inventory = ₹ 20,000 + ₹ 10,000

= ₹ 30,000

INTEXT QUESTIONS 32.2

Fill in the blanks with suitable word/words :

(i) Inventory turnover ratio is .... divided by average inventory.



Notes

(ii) Average inventory = $\dfrac{\text{Opening Inventory} + \text{..............................}}{2}$

(iii) Inventory turnover ratio = $\dfrac{10{,}000}{?}$ = 5 times

(iv) Inventory turnover ratio = $\dfrac{30{,}000}{10{,}000}$ =

(ii) Trade Receivable Turnover Ratio (Debtors Turnover ratio)

This ratio establishes a relationship between cost of revenue from operations and average trade receivables i.e. average trade debtors and bill receivables. The objective of computing this ratio is to determine the efficiency with which the trade receivables are managed. This ratio is also known as Ratio of Revenue from Operations (Net Sales) to Average Trade Receivables. It is calculated as under

Trade Receivable Turnover Ratio =

$$\frac{\text{Credit Revenue from Operations (Net Credit Sales)}}{\text{Average Trade Receivables}}$$

In case, figure of credit revenue from operations (net credit sale) is not available then the sales are treated as credit sales :

Average Trade Receivables =

$$\frac{\text{Opening Debtors \& Bills Receivable} + \text{Closing Debtors \& Bills Receivable}}{2}$$

Note : If opening trade receivables are not available, then closing trade receivables are taken as average trade receivables.

Significance

Debtors turnover ratio is an indication of the speed with which a company collects its debts. The higher the ratio, the better it is because it indicates that debts are being collected quickly. In general, a high ratio indicates the shorter collection period which implies prompt payment by debtor and a low ratio indicates a longer collection period which implies delayed payment for debtors.

Illustration 10

Find out trade receivable turnover from the following information for one year ended 31st March 2014.

	31st March 2014
Annual credit revenue from operations	500000
Trade receivable in the beginning	80000
Trade receivable at the end	100000

Solution

$$\text{Average Trade Receivables} = \frac{\text{Opening Trade Receivable} + \text{Closing Trade Receivable}}{2}$$

$$\text{Trade Receivables Turnover} = \frac{\text{Credit Revenue from Operations}}{\text{Average Trade Receivables}}$$

$$\text{Average Trade Receivables} = \frac{80{,}000 + 1{,}00{,}000}{2} = ₹\ 90{,}000$$

$$\text{Trade Receivable Turnover Ratio} = \frac{5{,}00{,}000}{90{,}000} = 5.56 \text{ times}$$

(iii) Trade Payables Turnover Ratio (Creditors Turnover Ratio)

It is a ratio between net credit purchases and average trade payables (i.e creditors and Bill payables). In the course of business operations, a firm has to make credit purchases. Thus a supplier of goods will be interested in finding out how much time the firm is likely to take in repaying the trade payables. This ratio helps in finding out the exact time a firm is likely to take in repaying to its trade payables. This ratio establishes a relationship between credit purchases and average trade payables.

$$\text{Trade Payables Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$$

$$\text{Average Trade Payables} = \frac{\text{Opening Creditors} + \text{Opening Bill Payables} + \text{Closing Creditors} + \text{Closing Bills Payables}}{2}$$

Significance

Trade Payables turnover ratio helps in judging the efficiency in getting the benefit of credit purchases offered by suppliers of goods. A high ratio indicates the shorter payment period and a low ratio indicates a longer payment period.

Illustration 11

Calculate trade payables turnover ratio from the following information :

	₹		₹
Cash purchases	1,00,000	Total purchases	4,07,000
Opening creditors	25,000	Closing creditors	50,000
Closing bill payables	25,000	Opening bill payables	20,000
Purchase returns	7,000		

Solution :

$$\text{Trade Payables Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$$

Net purchases = Total purchases – Purchase returns

= ₹ 407000 – ₹ 7000 = ₹ 400000

Net credit purchases = Net purchases – cash purchases

= ₹ 4,00,000 – ₹ 1,00,000

= ₹ 3,00,000

Average Trade Payables =

$$\frac{\text{Opening Creditors + Opening Bill Payables + Closing Creditors + Closing Bills Payables}}{2}$$

$$= \frac{₹25{,}000 + ₹20{,}000 + ₹5{,}000 + ₹25{,}000}{2}$$

$$= \frac{₹1{,}20{,}000}{2} = \text{Rs } 60{,}000$$

$$\text{Trade Payables Turnover Ratio} = \frac{₹3{,}00{,}000}{₹60{,}000} = 5 \text{ times}$$

Illustration 12

Calculate trade payables turnover ratio.

Credit purchases during the year	₹ 14,40,000
Closing creditors	₹ 1,44,000
Closing Bill payables	₹ 96,000

Solution :

$$\text{Trade Payables Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$$

Notes

$$= \frac{₹14,40,000}{₹1,44,000 + ₹96,000}$$

$$= \frac{₹14,40,000}{₹2,40,000} = 6 \text{ times}$$

Note : Where opening creditors and opening bill payables are not given then closing creditors and bill payables are taken as average trade payables.

Working Capital Turnover Ratio

Working capital of a concern is directly related to revenue from operations (sales). The current assets like debtors, bill receivables, cash, stock etc, change with the increase or decrease in revenue from operations.

Working Capital = Current Assets – Current Liabilities

Working capital turnover ratio indicates the speed at which the working capital is utilised for business operations. It is the velocity of working capital ratio that indicates the number of times the working capital is turned over in the course of a year. This ratio measures the efficiency at which the working capital is being used by a firm. A higher ratio indicates efficient utilisation of working capital and a low ratio indicates the working capital is not properly utilised.

This ratio can be calculated as

$$\text{Working Capital Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Working Capital}}$$

$$\text{Average Working Capital} = \frac{\text{Opening Working Capital} + \text{Closing Working Capital}}{2}$$

If the figure of cost of revenue from operations is not given, then the figure of revenue from operations (sales) can be used. On the other hand if opening working capital is not given then working capital at the year end will be used.

Illustration 13

Find out working capital turnover ratio for the year 2014.

	₹
Cash	10,000
Bills receivable	5,000
Sundry debtors	25,000
Inventory	20,000

Sundry creditors	30,000
Cost of Revenue from Operations	1,50,000

Solution :

$$\text{Working Capital Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Working Capital}}$$

Current Assets = ₹10,000 + ₹5,000 + ₹25,000 + ₹20,000

= ₹ 60,000

Current Liabilities = ₹ 30,000

Net working capital = CA – CL = ₹ 60,000 – ₹ 30,000

= ₹ 30,000

$$\text{So, Working Capital Turnover Ratio} = \frac{₹1,50,000}{₹30,000} = 5 \text{ times}$$

INTEXT QUESTIONS 32.3

I. Fill in the blanks with suitable word or words.

(i) Low trade receivables turnover ratio indicates .... collection.

(ii) Debtors turnover ratio = $\frac{\qquad\qquad}{\text{Average Trade Paybles}}$

(iii) ? = $\frac{\text{Net Credit Purchases}}{\text{Average Trade Paybles}}$

(iv) Trade Receivable Turnover Ratio = $\frac{?}{50,000} = 4$

(v) Trade Receivable turnover ratio = $\frac{1,50,000}{?} = 3$

(vi) Trade Payables turnover ratio = $\frac{75,000}{15,000} = ?$

(viii) Trade Payables turnover ratio = $\frac{1,00,000}{?} = 4$

II. Fill in the blanks with suitable word or words :

(i) Working capital = ... – current liabilities

(ii) .... = $\frac{\text{Cost of Revenue from Operations}}{\text{Average Working Capital}}$

(iii) Average working capital = $\dfrac{\text{Opening Working Capital} + \text{Closing Working Capital}}{?}$

(iv) Working Capital Turnover Ratio = $\dfrac{\text{Cost of Revenue from Operations}}{\text{Average Working Capital}}$

WHAT YOU HAVE LEARNT

- The term ratio means an arithmatical relationship between two numbers.
- Advantages and uses of Ratio Analysis
  - (i) Useful in Analysis of Financial Statements.
  - (ii) Useful in Simplying Accounting Figures.
  - (iii) Useful for Forecasting.
  - (iv) Useful in Locating the Weak spots.
- Liquidity ratios assesses the capacity of the firm to repay short term liability. It measures the ability to fulfil short term commitments out of liquid assets.
- The important liquidity ratios are :
  - (i) Current Ratio : It measures the short term solvency of a business

    Current Ratio = $\dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

  - (ii) Liquid Ratio : It measurs the ability of the firm to pay current liabilities immediately

    Liquid Ratio = $\dfrac{\text{Liquid Assets}}{\text{Current Liabilities}}$

    Liquid assets = Current assets – (Inventory + Prepaid expenses)
- Activity or turnover ratios measures the effectiveness with which a concern uses resources at its disposal.
- The important activity ratios are
  - (i) Inventory turnover ratio : It measures the efficiency with which the Inventory is managed.

    Inventory Turnover Ratio = $\dfrac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$

(ii) Trade Receivable turnover ratio : It is calculated to indicate the efficiency of the company to collect its debts.

$$\text{Trade Receivable Turnover Ratio} = \frac{\text{Revenue from Operations}}{\text{Average Trade Receivables}}$$

(iii) Trade Payable turnover ratio : It indicates the efficiency with which suppliers are paid.

$$\text{Trade Payable Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$$

Notes

TERMINAL EXERCISE

1. What are the Advantages and uses of ratio analysis? Explain in detail.
2. Explain the significance of trade receivable turnover ratio and liquid ratio.
3. Explain the meaning and significance of the following ratios.
   (a) Current ratio
   (b) Trade Payables turnover ratio
   (c) Inventory turnover ratio
4. From the following compute current ratio and quick ratio :

	₹
Fixed Assets	100000
Inventory	30000
Debtors	20,000
Cash	40,000
Prepaid expenses	10,000
Creditors	30,000
Reserves	10,000

5. Following figures have been extracted from the books of XY Ltd. as on 31st December 2013 is

	₹		₹
Equity share capital	100000	Cash in hand	20000
7% debentures	100000	Cash at Bank	20,000

Bank overdraft	40,000	Bill receivables	100000
Creditors	60000	Investment	10000
Debtors	50000	General reserve	30000
Inventory	150000		

Cost of Revenue from operations during the year 2014 were ₹ 4,70,000. Calculate inventory turnover ratio.

6. Given : Current ratio 5 : 2

   Liquidity ratio 3 : 2

   working capital ₹ 60,000

   Calculate (a) current liabilites (b) current assets (c) Liquid assets (d) stock

7. XYZ Ltd. supplies you following information regarding the year ending 31st, December 2013.

Cash sales	₹ 80,000
Credit sales	₹ 2,00,000
Return inward	₹ 10,000
Opening inventory	₹ 25,000
Closing inventory	₹ 30,000

Gross profit ratio is 25%. Calculate inventory turnover ratio.

ANSWERS TO INTEXT QUESTIONS

32.1 I. Cash at Bank, inventory, short term investment, Bills receivable, debtors, prepaid expenses, cash in hand

II. (i) current assets (ii) 2 : 1 (iii) 1 : 1 (iv) current assets

III. (i) False (ii) False

32.2 (i) Cost of revenue from operations (ii) Closing inventory

(iii) 2000 (iv) 3 times

32.3 I. (i) Delay in collection of debt

(ii) Net credit revenue from operations

(iii) Trade Payables turnover ratio

(iv) 2,00,000 (v) 50,000 (vi) 5 times (vii) 25,000

II. (i) Current assets (ii) Working capital turnover ratio

(iii) 2 (iv) Average working capital

ANSWERS TO TERMINAL EXERCISE

4. Current Ratio 3.33 : 1, Quick Ratio 2.337 : 1
5. 3.13 times
6. (a) 40,000 (b) 1,00,000 (c) 60,000 (d) 40,000
7. 7.36 times

33

ACCOUNTING RATIOS - II

You have learnt in the previous lesson that accounting ratios can be classified into four major groups viz. liquidity ratios, activity ratios, solvency ratios and profitability ratios. You have already learnt the meaning, computations and significance of liquidity and activity ratios. In this lesson, you will learn about the various solvency ratios and profitability ratios.

OBJECTIVES

After studying this lesson you will be able to :

- explain various types of accounting ratios i.e. solvency and profitability;
- calculate the various ratios on the basis of given information;
- describe the limitations of accounting ratios.

33.1 SOLVENCY RATIOS

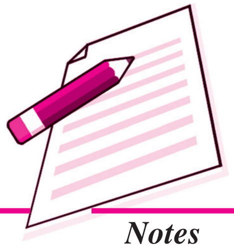
The term 'solvency' refers to the ability of a concern to meet its long term obligations. The long-term liability of a firm is towards debenture holders, financial institutions providing medium and long term loans and other creditors selling goods on credit. These ratios indicate firm's ability to meet the fixed interest and its costs and repayment schedules associated with its long term borrowings.

The following ratios serve the purpose of determining the solvency of the business firm.

- Debt equity Ratio
- Proprietary Ratio

Debt-equity Ratio

It is also otherwise known as external to internal equity ratio. It is calculated to know the relative claims of outsiders and the owners against the firm's assets. This ratio



Notes

establishes the relationship between the outsiders funds and the shareholders funds. Thus,

$$\text{Debt-equity Ratio} = \frac{\text{Outsiders' Funds}}{\text{Shareholders' Funds}}$$

The two basic components of the ratio are outsiders' funds and shareholders' funds. The outsiders' funds include all debts/liabilities to outsiders i.e. debentures, long term loans from financial institutions, etc. Shareholders' funds mean preference share capital, equity share capital, reserves and surplus and fictitious assets like preliminary expenses. This ratio indicates the proportion between shareholders' funds and the long-term borrowed funds. In India, this ratio may be taken as acceptable if it is 2 : 1. If the debt-equity ratio is more than that, it shows a rather risky financial position from the long term point of view.

Significance

The purpose of debt equity ratio is to derive an idea of the amount of capital supplied to the concern by the proprietors. This ratio is very useful to assess the soundness of long term financial position of the firm. It also indicates the extent to which the firm depends upon outsiders for its existence. A low debt equity ratio implies the use of more equity than debt.

Illustration 1

From the following, calculate the debt-equity ratio

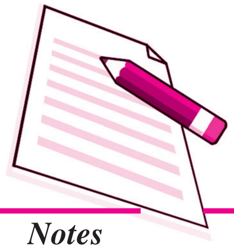
	₹
Equity Shares Capital	1,00,000
General Reserve	45,000
Accumulated Profits	30,000
Debentures	75,000
Sundry trade creditors	40,000
Outstanding expenses	10,000

Solution :

$$\text{Debt-equity Ratio} = \frac{\text{Debt (Total Long term Loans)}}{\text{Equity (Shareholders Funds)}}$$

$$= \frac{₹75{,}000}{₹1{,}75{,}000} = 3 : 7$$

Working Notes : Shareholders' Fund = Equity Share Capital + Reserves + Accumulated Profits



Notes

(i) ₹ 1,00,000 + ₹ 45,000 + ₹ 30,000 = ₹ 1,75,000

(ii) Long term debt = Debentures = ₹ 75,000

Illustration 2

Calculate the debt-equity ratio from the following data :

Total Assets ₹1,20,000. Total debts ₹1,00,000 current liabilities ₹ 60,000.

Solution :

Calculation of debt-equity ratio

Long Term Debt	=	Total debt – current liabilities
	=	₹ 1,00,000 – ₹ 60,000
	=	₹ 40,000
Shareholders' Fund	=	Total Assets – total debt
	=	₹ 1,20,000 – ₹ 1,00,000
	=	₹ 20,000
Debt Equity Ratio	=	$\frac{\text{Debt (Total Long term Loans)}}{\text{Equity (Shareholders Funds)}}$
	=	$\frac{₹45,000}{₹20,000} = 2$

Proprietory Ratio

It is also known as equity ratio. This ratio establishes the relationship between shareholders' funds to total assets of the firm. The shareholders' funds is the sum of equity share capital, preference share capital, reserves and surpluses. Out of this amount, accumulated losses should be deducted. On the other hand, the total assets mean total resources of the concern. The ratio can be calculated as under:

$$\text{Proprietory Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Assets}}$$

Significance

Proprietary ratio throws light on the general financial position of the enterprise. This ratio is of particular importance to the creditors who can ascertain the proportion of shareholders' funds in the total assets employed in the firm. A high ratio shows that there is safety for creditors of all types. Higher the ratio, the better it is for concern.

A ratio below 50% may be alarming for the creditors since they may have to lose heavily in the event of company's liquidation on account of heavy losses.

Notes

Illustration 3

From the following calculate the proprietary ratio :

	₹
Equity share capital	1,00,000
Preference share capital	50,000
Reserves and surpluses	25,000
Debentures	60,000
Creditors	15,000
Total	2,50,000
Fixed assets	1,25,000
Current Assets	50,000
Investment	75,000
Total	2,50,000

Solution :

$$\text{Proprietary Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Assets}}$$

$$= \frac{\text{Equity Share Capital} + \text{Preference Share Capital} + \text{Reserve \& Surpluses}}{\text{Total Asset}}$$

$$= \frac{₹1,75,000}{₹2,50,000} = 0.7 \text{ or } 70\%$$

Interest Coverage Ratio

This ratio establishes the relationship between Net Profit before Interest and Tax and Interest on long-term debts. It is calculated as follows :

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Debts}}$$

Illustration 4

X Ltd. has a 10% long-term loan of ₹ 20,00,000. Its net profit before interest and tax was ₹ 9,00,000. Calculate interest coverage ratio.

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Debts}}$$

Notes

Net profit before interest and tax = 9,00,000

Interest on long term loan = $\frac{10}{100}$ X 20,00,000 = 2,00,000

∴ Interest Coverage ratio = $\frac{9,00,000}{2,00,000}$ = 4.5 times

Significance

This ratio is very useful to the long term lending agencies like debenture holders and lenders of long term funds as it indicates the number of times the interest on long term funds is covered by profits. A high ratio is considered better for the lenders because it provides higher safety margin.

INTEXT QUESTIONS 33.1

Fill in the blanks with suitable word/words/figures :

(i) Debt equity ratio = ...

(i) .... ratio measures the long term obligation of a firm.

(iii) .... = $\frac{\text{Shareholders' Funds}}{\text{Total Assets}}$

(iv) Debt equity ratio = $\frac{2,00,000}{3,00,000}$ = ...

33.2 PROFITABILITY RATIOS

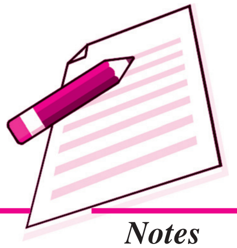
The main aim of an enterprise is to earn profit which is necessary for the survival and growth of the business enterprise. It is earned with the help of amount invested in business. It is necessary to know how much profit has been earned with the help of the amount invested in the business. This is possible through profitability ratios. These ratios examine the current operating performance and efficiency of the business concern. These ratios are helpful for the management to take remedial measures if there is a declining trend. The important profitability ratios are :

(i) Gross Profit Ratio

(ii) Net Profit Ratio

(iii) Operating Profit Ratio

(iv) Return on Investment Ratio



Notes

(i) Gross Profit Ratio

It expresses the relationship of gross profit to revenue from operations (net sales). It is expressed in percentage. It is computed as

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

where,

Net Sales = Total sales – (sales returns + excise duty)

Gross Profit = Revenue from operations – Cost of revenue from operations

Significance

Gross profit ratio shows the margin of profit. A high gross profit ratio is a great satisfaction to the management. It represents the low cost of revenue from operations. Higher the rate of gross profit, lower the cost of revenue from operations.

Illustration 5

From the following detail of a business concern ascertain the gross profit ratio:

Details	*2013 (₹)*	*2014 (₹)*
Revenue from operations (sales)	120,000	160,000
Gross profit	40,000	60,000

Solution :

2013 Gross Profit Ratio $= \frac{₹\ 40{,}000}{₹\ 1{,}20{,}000} \times 100 = 33.33\%$

2014 Gross Profit Ratio $= \frac{₹\ 60{,}000}{₹\ 1{,}60{,}000} \times 100 = 37.5\%$

Illustration 6

Calculate the gross profit ratio from the following data :

Sales ₹ 3,25,000 sales returns ₹ 25,000 and cost of revenue from operations ₹ 2,40,000.

Solution :

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

Gross Profit = Net sales – Cost of revenue from operations

$$= 300{,}000 - 2{,}40{,}000 = 60{,}000$$

$$\text{Gross Profit Ratio} = \frac{₹\ 60{,}000}{₹\ 3{,}00{,}000} \times 100 = 20\%$$

Note : Net Sales = Sales - Sales return = 3,25,000 - 25,000 = ₹ 3,00,000

(ii) Net Profit Ratio

A ratio of net profit to revenue from operations (sales) is called Net profit ratio. It indicates sales margin on sales. This is expressed as a percentage. The main objective of calculating this ratio is to determine the overall profitability. The ratio is calculated as:

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

Significance

Net profit ratio determines overall efficiency of the business. It indicates the extent to which management has been effective in reducing the operational expenses. Higher the net profit ratio, better it is for the business.

Illustration 7

Calculate Net profit ratio from the following :

Net Profit	₹ 45,000
Sales	₹ 6,40,000
Sales Returns	₹ 40,000

Solution :

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\text{Net Sales} = \text{Sales} - \text{Sales returns}$$

$$= ₹\ 640{,}000 - ₹\ 40{,}000 = ₹\ 600{,}000$$

$$\text{Net profit ratio} = \frac{₹\ 45{,}000}{₹\ 6{,}00{,}000} \times 100 = 7.5\%$$

Illustration 8

Calculate gross profit ratio and net profit ratio from the following figures.

Revenue from operations (Sales)	₹ 1,50,000
Cost of revenue from operations	₹ 1,20,000
Operating expenses	₹ 12,000

Solution :

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\text{Gross Profit} = \text{Sales} - \text{Cost of revenue from operations}$$

$$= ₹\ 150{,}000 - ₹\ 120{,}000$$

$$= ₹\ 30{,}000$$

$$\text{Gross Profit Ratio} = \frac{₹\ 30{,}000}{₹1{,}50{,}000} \times 100 = 20\%$$

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\text{Net Profit} = \text{Gross Profit} - \text{Operating Expenses}$$

$$= ₹\ 30{,}000 - ₹\ 12{,}000$$

$$= ₹\ 18{,}000$$

$$\text{Net Profit Ratio} = \frac{₹\ 18{,}000}{₹\ 1{,}50{,}000} \times 100 = 7.5\%$$

(iii) Operating Profit Ratio

Operating profit is an indicator of operational efficiencies. It reveals only overall efficiency. It establishes relationship between operating profit and revenue from operation (net sales). This ratio is expressed as a percentage. It is calculated as:

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

Operating Profit = Gross Profit – (Administration expenses + selling expenses)

Significance

It helps in examining the overall efficiency of the business. It measures profitability and soundness of the business. Higher the ratio, the better is the profitability of the business. This ratio is also helpful in controlling cash.

Illustration 9

From the following details of a business concern ascertain the operating profit ratio

Details	*2013* ₹	*2014* ₹
Revenue from Operations (Sales)	60,000	80,000

Interest on Debentures	1,000	2,000
Net Profit	3,800	6,000

Solution :

2013

Net profit before interest = Net profit + Interest

= ₹ 3,800 + ₹ 1,000

= ₹ 4,800

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\text{Operating Profit Ratio} = \frac{₹\ 4,800}{₹\ 60,000} \times 100 = 8\%$$

2014

Net Profit before Interest = ₹ 6,000 + ₹ 2,000

= ₹ 8000

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\text{Operating Profit Ratio} = \frac{₹\ 8,000}{₹\ 80,000} \times 100 = 10\%$$

Some firms take profit before tax but usually companies take profit after tax.

Illustration 10

Calculate operating profit ratio from the following data :

	₹
Revenue from Operation (Sales)	3,00,000
Gross profit	1,20,000
Administration expenses	35,000
Selling and distribution expenses	25,000
Income on investment	15,000
Loss by fire	9,000

Solution :

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$= \frac{₹\,60{,}000}{₹\,3{,}00{,}000} \times 100 = 20\%$$

Note : Operating Profit = Gross profit – (Administration expenses + Selling expenses)

= ₹ 1,20,000 – (₹ 35,000 + ₹ 25,000)

= ₹ 1,20,000 – ₹ 60,000

= ₹ 60,000

INTEXT QUESTIONS 32.2

Fill in the blanks with suitable word/words :

(i) Gross profit ratio = ... X 100

(ii) .... = $\frac{\text{Operating Profit}}{\text{Net Sales}} \times 100$

(iii) Name the ratios that relate to the profitability of a business concern ....

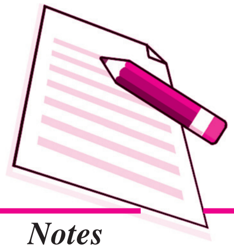
33.3 LIMITATIONS OF ACCOUNTING RATIOS

Accounting ratios are very significant in analysing the financial statements. Through accounting ratios, it will be easy to know the true financial position and financial soundness of a business concern. However, despite the advantages of ratio analysis, it suffers from a number of limitations. The following are the main limitations of accounting ratios.

- **Ignorance of Qualitative Aspect :** The ratio analysis is based on quantitative aspect. It totally ignores qualitative aspect which is sometimes more important than quantitative aspect.

- **Ignorance of Price Level Changes :** Price level changes make the comparison of figures difficult over a period of time. Before any comparison is made, proper adjustments for price level changes must be made.

- **No Single Concept :** In order to calculate any ratio, different firms may take different concepts for different purposes. Some firms take profit before charging interest and tax or profit before tax but after interest tax. This may lead to different results.



Notes

- **Misleading Results if based on Incorrect Accounting Data :** Ratios are based on accounting data. They can be useful only when they are based on reliable data. If the data are not reliable, the ratio will be unreliable.
- **No Single Standard Ratio for Comparison :** There is no single standard ratio which is universally accepted and against which a comparison can be made. Standards may differ from Industry to industry.
- **Difficulties in Forecasting :** Ratios are worked out on the basis of past results. As such they do not reflect the present and future position. It may not be desirable to use them for forecasting future events.

WHAT YOU HAVE LEARNT

- The term solvency ratio means ability of a concern to meet its long-term obligations. The solvency ratios are :

  Debt-equity ratio

  Proprietary ratio
- The purpose of debt equity ratio is to derive an idea of the amount of capital supplied to the concern by the proprietary.

$$\text{Debt Equity Ratio} = \frac{\text{Outsiders' Fund}}{\text{Shareholders' Fund}} \quad \text{or} \quad \frac{\text{Debt}}{\text{Equity}}$$

- Proprietary ratio establishes relationship between shareholders' funds to total assets of the firm

$$\text{Proprietary Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Assets}}$$

- Profitability ratio assesses the overall efficiency of the business concern.
- Important profitability ratios are :

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$$

- Limitations of accounting ratios are
  - ignorance of price level changes
  - ignorance of qualitative factors
  - no single concept
  - misleading result if based on incorrect accounting data
  - difficulties in forecasting

TERMINAL EXERCISE

1. Explain solvency ratios in brief.
2. What are profitability ratios? Explain the ratios in brief.
3. What are the limitations of ratio analysis?
4. What is meant by gross profit and net profit ratio?
5. From the following data, calculate (a) Gross profit ratio (b) Net profit ratio.

	₹
Revenue from operations (Sales)	25,20,000
Cost of revenue from operations	19,20,000
Net profit	3,60,000

6. Total assets ₹ 12,50,000, Total debt ₹ 10,00,000 current labilities ₹ 500,000. Calculate debt-equity ratio.
7. Following figures have been obtained from the statement of Profit and Loss of M/s Bunu Ltd. for the year 31st December, 2013.

	₹		₹
Opening Inventory	100000	Revenue from operations	560000
Purchases	350000	Closing Inventory	100000
Wages	9000	Administrative expenses	20000
Salary and administrative expense	89000	Interest on investment	10000
Non-operating expenses	30000	Profit on sale of investment	8000

You are required to calculate (a) Gross profit ratio (b) Net profit ratio (c) Operating profit ratio.

8. Following particulars pertaining to assets and liabilities of XYZ Ltd. are given:

Liabilities	*Amount (₹)*	*Assets*	*Amount (₹)*
Equity share capital	250000	Land and Building	450000
Preference share capital	200000	Plant	400000
Reserves	200000	Inventory	150000
Debentures	300000	Sundry debtors	100000
Current liabilities	200000	Cash	45000
		Prepaid expenses	5000

Calculate (a) debt equity ratio (b) proprietory ratio.

ANSWERS TO INTEXT QUESTIONS

33.1 (i) $\frac{\text{Outsiders' Fund}}{\text{Shareholders' Fund}}$ (ii) Solvency

(iii) Proprietary ratio (iv) 2 : 3

33.2 (i) $\frac{\text{Gross Profit}}{\text{Net Sales}}$ (ii) Operating profit ratio

(iii) Gross profit ratio, Net profit ratio, Return on investments, operating profit ratio

ANSWERS TO TERMINAL EXERCISE

5. (a) 23.8% (b) 14.29%
6. 2 : 1
7. (a) 35.89%, (b) 14.29% (c) 16.43%
8. (a) 0.46 : 1, (b) 56.52 : 1

ACTIVITY

Visit the office of a stock broker in the nearby market and ask annual report of two joint stock companies. Study the Banace Sheets of the two companies and compute the following ratios :

(a) Debt Equity Ratio (b) Gross Profit Ratio (c) Net Profit Ratio

Compare and comment on the profitability and solvency efficiency of the two companies.

34

CASH FLOW STATEMENT

In the previous lesson, you have learnt various types of analysis of financial statements and its tools such as comparative statements, common size statement and trend analysis, etc. You have also learnt various kinds of accounting ratios such as liquidity, activity, profitability, solvency, etc. You have learnt that accounts are mainly maintained on accrual basis but cash also plays significant role. Cash is mainly generated from operating activities which is buying assets and discharging liabilities. Cash is also raised from the issue of shares and debentures or loans but adequate cash should be made available for use in time and no cash should remain idle. For this another tool of analysis is used which is cash flow statement.. In this lesson, you will learn about cash flow statement and its methods of preparation.

OBJECTIVES

After studying this lesson, you will be able to :

- state the meaning of cash flow statement;
- explain objectives of cash flow statement;
- explain the method of preparing cash flow statement as per format;
- state the limitations of cash flow statement.

34.1 MEANING AND OBJECTIVES

Cash plays a very important role in the economic life of a business. A firm needs cash to make payment to its suppliers, to incur day-to-day expenses and to pay salaries, wages, interest and dividends etc. In fact, what blood is to a human body, cash is to a business enterprise. Thus, it is very essential for a business to maintain an adequate balance of cash. For example, a concern operates profitably but it does not have

sufficient cash balance to pay dividends, what message does it convey to the shareholders and public in general. Thus, management of cash is very essential. There should be focus on movement of cash and its equivalents. Cash means, cash in hand and demand deposits with the bank. Cash equivalent consists of bank overdraft, cash credit, short term deposits and marketable securities.

Cash Flow Statement deals with flow of cash which includes cash equivalents as well as cash. This statement is an additional information to the users of Financial Statements. The statement shows the incoming and outgoing of cash. The statement assesses the capability of the enterprise to generate cash and utilize it. *Thus a Cash-Flow statement may be defined as a summary of receipts and disbursements of cash for a particular period of time. It also explains reasons for the changes in cash position of the firm.* Cash flows are cash inflows and outflows. Transactions which increase the cash position of the entity are called as inflows of cash and those which decrease the cash position as outflows of cash. Cash flow Statement traces the various sources which bring in cash such as cash from operating activities, sale of current and fixed assets, issue of share capital and debentures etc. and applications which cause outflow of cash such as loss from operations, purchase of current and fixed assets, redemption of debentures, preference shares and other long-term debt for cash. In short, a cash flow statement shows the cash receipts and disbursements during a certain period. The statement of cash flow serves a number of objectives which are as follows :

- Cash flow statement aims at highlighting the cash generated from operating activities.
- Cash flow statement **helps in planning the schedule for repayment of loan** schedule and replacement of fixed assets, etc.
- Cash is the centre of all financial decisions. It is used as the basis for the projection of future investing and financing plans of the enterprise.
- Cash flow statement helps to ascertain the liquid position of the firm in a better manner. Banks and financial institutions mostly prefer cash flow statement to analyse liquidity of the borrowing firm.
- Cash flow Statement helps in efficient and effective management of cash.
- The management generally looks into cash flow statements to understand the internally generated cash which is best utilised for payment of dividends.
- Cash Flow Statement based on AS-3 (revised) presents separately cash generated and used in operating, investing and financing activities.
- It is very **useful in the evaluation of cash position** of a firm.

Cash and Relevant Terms as per AS-3 (Revised)

As per AS-3 (revised) issued by the Accounting Standards Board

1. (a) Cash fund :

   Cash Fund includes (i) Cash in hand

   (ii) Demand deposits with banks, and

   (iii) cash equivalents.

   (b) Cash equivalents are short-term, highly liquid investments, readily convertible into cash and which are subject to insignificant risk of changes in values.

2. Cash Flows are inflows and outflows of cash and cash equivalents.

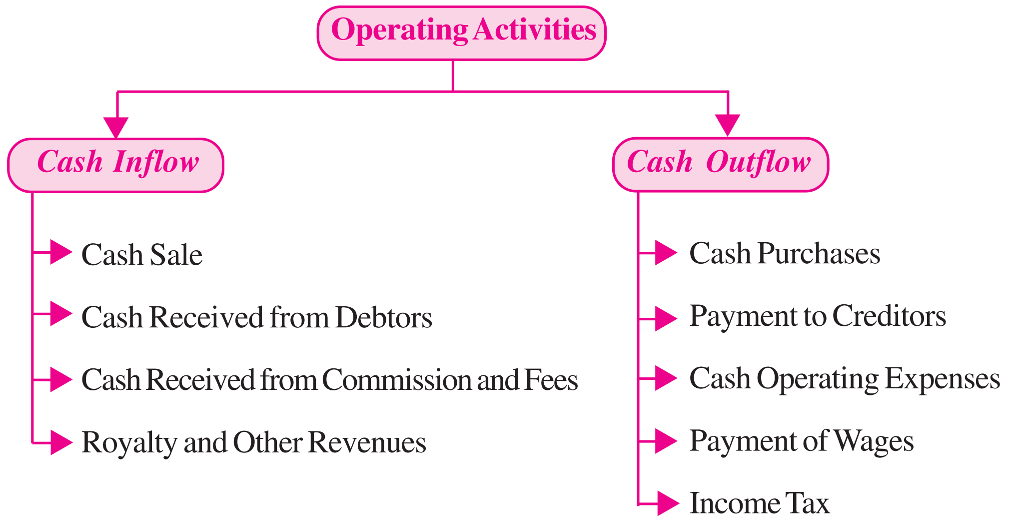
   The statement of cash flow shows three main categories of cash inflows and cash outflows, namely : operating, investing and financing activities.

   (a) **Operating activities** are the principal revenue generating activities of the enterprise.

   (b) **Investing activities** include the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

   (c) **Financing activities** are activities that result in change in the size and composition of the owner's capital (including Preference share capital in the case of a company) and borrowings of the enterprise.

As per AS-3 the inflow and outflow of cash are :



Notes

Investing Activities

- ***Cash Inflow***
  - Sale of Fixed Assets
  - Sale of Investment
  - Interest Received
  - Dividend Received
- ***Cash Outflow***
  - Purchase of Fixed Assets
  - Purchase of Investment

Financing Activities

- ***Cash Inflow***
  - Issue of Shares
  - Issue of Debentures in Cash
  - Proceeds from long term / short term borrowing
- ***Cash Outflow***
  - Cash Repayment of amounts borrowed
  - Interest Paid on Loans / Debentures
  - Dividends Paid on Equity and Preference share Capital

INTEXT QUESTIONS 34.1

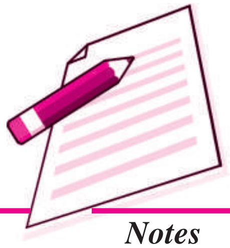
Fill in the blanks with suitable word/words :

(i) Cash flow statement deals with flow of cash which includes cash and ....

(ii) Cash flow statement is a .... statement.

(iii) Cash flow statement shows .... and .... during a particular period.

(iv) As per AS 3 (revised), cash fund includes cash, demand deposit with bank and ....



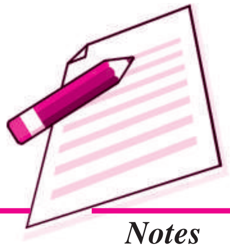
Notes

34.2 METHOD OF PREPARING CASH FLOW STATEMENT

Format of Cash Flow Statement
for the year ended ....
As per Accounting Standard - 3 (Revised)

	Particulars		₹
(i)	Cash flows from operating Activities	xxx	xxx
	Net Profit as per Statement of Profit and Loss or difference between closing balance and opening balance of Statement of Profit and Loss		
	Add : Transfer to reserve	xxx	
	Proposed dividend for current year	xxx	
	Interim dividend paid during the year	xxx	
	Provision for tax made during the current year	xxx	
	Extraordinary items, if any, shown in statement of Profit and Loss	xxx	xxx
		xxx	xxx
	Less : Extraordinary Items, if any, shown in statement of Profit and Loss	xxx	
	Refund of Tax credited to be shown in statement Profit and Loss	xxx	xxx
A.	Net profit before taxation and Extra ordinary items		
	Adjustment for Non-Cash and Non-Operating Items.	xxx	xxx
B.	Add :		
	– Depreciation	xxx	
	– Preliminary expenses written off	xxx	
	– Discount on issue of shares and debentures written off	xxx	
	– Interest on borrowings and debentures	xxx	
	– Loss on sale of fixed assets	xxx	xxx
			xxx
C.	Less :		
	– Interest income/received	xxx	
	– Dividend income received	xxx	
	– Rental income received	xxx	
	– Profit on sale of fixed assets	xxx	xxx
			xxx
D.	Operating profit before working capital changes		
	(A + B – C)	xxx	
			xxx
E.	*Add :* Decrease in current assets and increase in current liabilities		xxx

F.	***Less :*** Increase in current assets and decrease in current liabilities	xxx	
G	Cash generated from operations (D + E – F)		xxx
H.	Less : Income tax paid (Net tax refund received)		xxx
I.	Cash flow from operating activities before extraordinary items		xxx
	Adjusted extraordinary items (+/–)		xxx
J.	Net cash from operating activities		xxx
(ii)	Cash from Investing Activities		
	Add :		
	– Proceeds from sale of fixed assets		xxx
	– Proceeds from sale of investments		xxx
	– Proceeds from sale of intangible assets		xxx
	– Interest and dividend received		xxx
	– Rental Income		xxx
			xxx
	Less :		
	– Purchase of fixed assets	xxx	
	Purchase of investment	xxx	
	– Purchase of intangible assets like goodwill	xxx	xxx
			xxx
	Adjusted extraordinary items (+/–)		xxx
	Net cash from (or used in) investing activities		xxx
			xxx
(iii)	Cash flows from financing activities		
	Add :		
	Proceeds from issue of shares and debentures	xxx	
	Proceeds from other long term borrowings	xxx	
		xxx	
	Less :		
	Final dividend paid	xxx	
	Interim dividend paid	xxx	
	Interest on debentures and loans paid	xxx	
	Repayment of loans	xxx	
	Redemption of debenture and preference shares	xxx	xxx
	Adjusted extraordinary items (+/–)	xxx	xxx
	Net cash from (or used in) financing activities		xxx
			xxx
(iv)	Net increase/Decrease in cash and cash equivalent (i + ii + iii)		xxx



(v)	Add : cash and cash equivalents in the beginning of the year		
–	cash in hand	xxx	
–	cash at bank (Bank overdraft)	xxx	
–	short term deposit	xxx	
–	marketable securities	xxx	
–	cash and cash equivalents in the end of the year		xxx
–	cash in hand	xxx	
–	cash at Bank (by bank overdraft)	xxx	
–	short term deposits	xxx	
–	Marketable Securities	xxx	xxx

Some facts about cash flow statement :

(i) Only listed companies are required to prepare and present Cash flow statement.

(ii) The Accounting period for the Cash Flow Statement is the same for which Profit and Loss Account and Balance Sheet are prepared.

(iii) Cash flow items are as (a) Cash flow from operating activities :(b) Cash flow from investing activities (c) Cash flow from financing activities.

(iv) Operating activities include revenue producing activities which are not investing and financing activities.

(v) There are two methods of calculating cash flow from operating activities namely Direct method and Indirect method. SEBI (Securities Exchange Board of India) Guidelines recommend for only direct method.

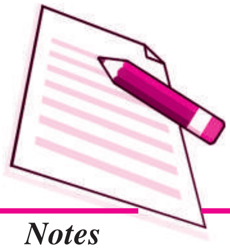
(vi) Extra ordinary Items : The Cash flow associated with extra ordinary items should be classified as arising from operating, investing and financing activities. For example, the amount received from Insurance Company on account of Loss of Stock or loss from earthquake should be reported as cash flow from operating activities.

INTEXT QUESTIONS 34.2

Fill in the blanks with appropriate word/words :

(i) Only .... companies prepare cash flow statement.

(ii) Cash flows are classified in to three parts i.e. operating activities, financing activities and .... activities.



Notes

34.3 PREPARATION OF CASH FLOW STATEMENT

(i) Operating Activities

Cash flow from operating activities are primarily derived from the principal revenue generating activities of the enterprise. A few items of cash flows from operating activities are :

(i) Cash receipt from the sale of goods and rendering services.

(ii) Cash receipts from royalties, fee, Commissions and other revenue.

(iii) Cash payments to suppliers for goods and services.

(iv) Cash payment to employees

(vi) Cash payment or refund of Income tax.

Determination of cash flow from operating activities

There are two stages for arriving at the cash flow from operating activities

Stage-I

Calculation of operating profit before working capital changes, It can be calculated in the following manner.

Net profit before Tax and extra ordinary Items		xxx	
Add :	Non-cash and non operating Items which have already been debited to profit and Loss Account i.e.		
	Depreciation	xxx	
	Amortisation of intangible assets	xxx	
	Loss on the sale of Fixed assets.	xxx	
	Loss on the sale of Long term Investments	xxx	
	Provision for tax	xxx	
	Dividend paid	xxx	xxx
		xxx	
Less :	Non-cash and Non-operating Items which have already been credited to Profit and Loss Account i.e.		
	Profit on sale of fixed assets	xxx	
	Profit on sale of Long term investment	xxx	xxx
	Operating profit before working Capital changes.		xxx

Notes

Stage-II

After getting operating profit before working capital changes as per stage I, adjust increase or decrease in the current assets and current liabilities.

The following general rules may be applied at the time of adjusting current assets and current liabilities.

A. Current Assets

(i) An increase in an item of current assets causes a decrease in cash inflow because cash is blocked in current assets.

(ii) A decrease in an item of current assets causes an increase in cash inflow because cash is released from the sale of current assets.

B. Current Liabilities

(i) An increase in an item of current liability causes a decrease in cash outflow because cash is saved.

(ii) A decrease in an item of current liability causes increase in cash out flow because of payment of liability.

Thus,

Cash from Operations = Operating Profit before Working Capital Changes + Net decrease in Current Assets + Net Increase in Current Liabilities – Net increase in Current Assets – Net decrease in Current Liabilities.

Illustration 1

The net Income reported in the Income Statement for the year was ₹ 110,000 and depreciation on fixed assets for the year was ₹ 44000. The balances of the current assets and current liabilities at the beginning and at the end of the year were as follows. Calculate cash from operating activities.

Current Items	*End of the year Amount (₹)*	*Beginning of the year Amount (₹)*
Cash	130,000	140,000
Debtors	200,000	180,000
Inventories	290,000	300,000
Prepaid expenses	15,000	16,000
Account payables	102,000	1,16,000

Solution :

Step - I

Cash from Operating Activities

Details			*Amount (₹)*
Net Income			1,10,000
Adjustment for non cash and Non-operating items			
Add Depreciation			44,000
Operating Profit before working capital changes			154,000
Current Assets :			
Add :	(a) Decrease in inventories	10,000	
	(b) Decrease in prepaid expenses	1000	11000
			1,65,000
Deduct :	(a) Increase in Debtors Current Liabilities	(20,000)	
	(b) Decrease in Account payables	(14,000)	34,000
Net Cash flow from operating Activities			1,31,000

Step - II

Investing Activities

Investing Activities refer to transactions that affect the purchase and sale of fixed or long term assets and investments.

Examples of cash flow arising from Investing activities are

1. Cash payments to acquire fixed Assets
2. Cash receipts from disposal of fixed assets
3. Cash payments to acquire shares, or debenture as investment.
4. Cash receipts from the repayment of advances and loans made to third parties.

Thus, Cash inflow from investing activities are

- Cash sale of plant and machinery, land and Building, furniture, goodwill etc.
- Cash sale of investments made in the shares and debentures of other companies
- Cash receipts from collecting the Principal amount of loans made to outsiders.

Cash outflow from investing activities are

- Purchase of fixed assets i.e. land, Building, furniture, machinery etc.
- Purchase of Intangible assets i.e. goodwill, trade mark etc.
- Purchase of shares and debentures
- Purchase of Government Bonds
- Loan made to outsiders.

Illustration 2

From the following information calculate the cash flow from investing activities

Particulars	*Opening*	*Closing*
Machinery (at cost)	4,00,000	4,20,000
Accumulated Depreciation	1,00,000	1,10,000
Patents	2,80,000	1,60,000

Additional Information :

(i) During the year a machine costing ₹ 40,000 with this accumulated depreciation ₹ 24000 was sold for ₹ 20,000

(ii) Patents were written off to the extent of ₹ 40,000 and some patents were sold at a profit of ₹ 20,000

Solution :

Cash Flow from Investing Activities

Particulars	₹
Inflow from sale of machinery	20,000
Inflow from sale of patent (2)	1,00,000
	1,20,000
Outflow on purchase of machinery (1)	(60,000)
Net cash flow from investing activities	60,000

Working Notes :

Machinery A/c

Balance b/d	4,00,000	Bank (Inflow)	20,000
Statement of Profit and Loss (Profit on sale of machine)	4,000	Accumulated depreciation (Depreciation on machinery sold)	24,000

Bank A/c	60000	Balance c/d	420000
	464000		464000

Patent A/c

Balance b/d	2,80,000	Bank A/c (Inflow) Bal. Fig.	1,00,000
Statement of Profit and Loss	20,000	Statement of Profit and Loss	40,000
(Profit)		Balance c/d	1,60,000
	3,00,000		300000

Step - III

Financing Activities

The third section of the cash flow statement reports the cash paid and received from activities with non-current or long term liabilities and shareholders Capital. Examples of cash flow arising from financing activities are

- Cash proceeds from issue of shares or other similar instruments.
- Cash proceeds from issue of debentures, loans, notes, bonds, and other short-term borrowings
- Cash repayment of amount borrowed

Cash Inflow from financing activities are :

- Issue of Equity and preference share capital for cash only.
- Issue of Debentures, Bonds and long-term notes for cash only

Cash outflow from financing activities are :

- Payment of dividends to shareholders
- Redemption or repayment of loans i.e. debentures and bonds
- Redemption of preference share capital
- Buy back of equity shares.

Illustration 3

From the following information. Calculate the Cash from financing activities:

Particulars	*31.12.2006* ₹	*31.12.2007* ₹
Equity share capital	4,00,000	5,00,000
10% debentures	1,50,000	1,00,000
Securities premium	40,000	50,000

Notes

Additional Information : Interest paid on debentures ₹10000.

Solution :

Calculation of Cash from financing activities

Particulars		₹
Cash proceeds from the issue of shares		1,10,000
(Including premium)		
Interest paid on debentures	10,000	
Redemption of debentures	50,000	60,000
		50,000

Illustration 4

Classify the following into cash flows from operating activities, investing activities and financing activities

(a) Cash sale of goods

(b) Cash paid to suppliers of raw material

(c) Cash payments of salaries and wages to employees.

(d) Cash payment to acquire fixed assets

(e) Cash proceeds from issues of shares at premium.

(f) Payment of dividend

(g) Interest received on investments

(h) Interest on debentures

(i) Payment of income tax

(j) Cash payment of long term loans

Solution

A. Cash Flow from operating Activities

(a) **Cash sale of goods :** Normal business activity of selling Inventories or goods (Cash inflow)

(b) **Cash paid to suppliers** of raw materials

Routine payments for purchasing the goods (Cash outflow)

(c) **Cash payment of salaries and wages :**

Cash payments to employees for their services in the office (Cash outflow)

Notes

(i) **Payment of Income Tax :** Payment of tax on business Income (Cash outflow)

B. Cash Flow from investing Activities

(a) **Cash payment to acquire fixed assets :** Purchase of long term assets (Cash outflow)

(b) **Interest received on Investments :** It is an Income on Investments (Cash inflow)

C. Cash Flow from financing Activities

(a) Cash proceeds from issuing shares at premium : (Cash inflow)

(b) **Payment of dividends :** It is related to issue of share capital, a (Cash outflow)

(c) **Interest paid on debentures :** Payment associated with loan capital (Cash outflow)

(i) **Cash payment of a long term loan :** Redemption of loan or borrowed capital (Cash outflow)

INTEXT QUESTIONS 34.3

Classify the following items into (i) Operating (ii) Investing and Financing activities.

(i) Refund of income tax

(ii) Payment of dividend to shareholders

(iii) Purchase of land and building

(iv) Purchase of plant

(v) Interest paid on debentures.

34.4 TREATMENT OF SPECIAL ITEMS

(i) **Payment of Interim Dividend :** The following procedure is followed

(a) The amount of interim dividend paid during the year is shown as outflow of cash in cash flow statement.

(b) It will be added back to the profits for the purpose of calculating cash provided from operating activities.

(c) No adjustment is necessary if the cash provided from operating activities is calculated on the basis of revised figure of net profit.

(ii) **Proposed Dividend :** The dividend is always declared in the general meeting after the preparation of Balance Sheet. It is therefore, a non-operating item which should not be permitted to affect the calculation of cash generated by operating activities. Thus, the amount of proposed dividends would be added back to current years profit and payments made during the year in respect of dividends would be shown as an outflow of cash.

(iii) **Share Capital :** The increase in share capital is regarded as inflow of cash only when there is an increase in share capital. For example, if a company issues 10000 equity shares of ₹ 10 each for cash only, ₹ 100,000 would be shown as inflow of cash from financing activities. Similarly, the redemption of preference shares is an outflow of cash. But where the share capital is issued to finance the purchase of fixed assets or the debentures are converted into equity shares there is no cash flow. Further, the issue of bonus shares does not cause any cash flows.

(iv) **Purchase or sale of fixed Assets :** The figures appearing in the comparative balance sheets at two dates in respect of fixed assets might indicate whether a particular fixed asset has been purchased or sold during the year. This would enable to determine the inflows or outflows of cash. For example, If the plant and machinery appears at ₹ 60,000 in the current year and ₹50,000 in the previous year, the only conclusion, in the absence of any other information is that there is a purchase of fixed assets for ₹10000 during the year. Hence, ₹10000 would be shown as outflow of cash.

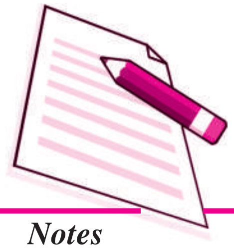
(v) **Provision for Taxation :** It is a non-operating expenses or an item of appropriation in the Income statement/Profit and Loss Account and therefore should not be allowed to reduce the cash provided from operating activities. Hence, if the profit is given after tax and the amount of the provision for tax made during the year is given, the same would be added back to the current year profit figure.

In the cash flow statement, the tax paid would be recorded separately as an outflow of cash. The item of provision for taxation, would not be treated as current assets.

Sometimes, the only information available about provision for taxation in the opening balance sheet and closing balance sheet. In such a case the figure in the opening balance sheet is treated as an outflow of cash while the figure in the closing balance sheet is treated as a non-cash and non-operating expense and thus is added back to net Income figure to find out the cash provided from operating activities.

Illustration 5

The comparative balance sheets of Bansal Private Limited at two different dates provide the following information.



Assets	*March 31, 2006 Amount (₹)*	*March 31, 2007 Amount (₹)*
Plant and machinery	13,50,000	14,40,000

It is informed that depreciation amounting to ₹ 60,000 has been provided during the year. Find the changes that have taken place in the asset and also state their effect on cash flows.

Solution :

In order to identify the transactions affecting the asset account, the proper procedure is to prepare the plant and machinery account as shown below:

Plant and Machinery Account

Particulars	*Amount*	*Particulars*	*Amount*
Balance b/d	13,50,000	Depreciation (given)	60,000
Bank A/c (New machine purchased)	1,50,000	Balance c/d	14,40,000
	15,00,000		15,00,000

Note

- In the absence of specific information, it may be presumed that the additional machinery was purchased for ₹1,50,000.
- The amount spent on the plant and machinery represents a reduction in the cash and its equivalent. It is, therefore, an example of outflow of cash.

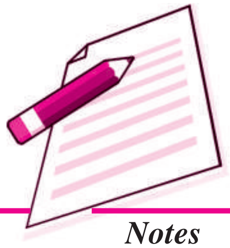
Illustration 6

In the comparative balance sheet of Wilson & Sons Ltd., the position of Building Account is given as under.

Liabilities	*March 31, 2013 Amount ₹*	*March 31, 2014 Amount ₹*	*Assets*	*March 31, 2013 Amount ₹*	*March 31, 2014 Amount ₹*
Accumulated depreciation (Building)	7,00,000	7,90,000	Building	3,84,0000	3,91,0000

Additional Information

A part of the building of ₹ 74,000 was sold for ₹ 60,000. The accumulated depreciation on building sold was ₹ 20,000 Analyse the transaction.



Notes

Solution

The different transactions affecting the building account are to be identified by preparing the following accounts :

Building Account

Dr | Cr.

Particulars	₹	*Particulars*	₹
Balance b/d	38,40,000	Cash (Inflow)	60,000
Statement of Profit and loss (gain on sale)	6,000	Accumulated Depreciation A/c	20,000
Bank A/c			
Purchase (outflow)	1,44,000	Balance c/d	39,10,000
	39,90,000		39,90,000

Accumulated Depreciation Account

Dr | Cr.

Particulars	₹	*Particulars*	₹
Building A/c	20,000	Balance b/d	7,00,000
Balance c/d	7,90,000	Statement of Profit and Loss	1,10,000
	8,10,000		8,10,000

Note

- The gain on sale of building (i.e. ₹ 6000) would be deducted from the reported Income (or profit)
- Purchase of building for ₹144,000 is identified from the balancing figure in the Building account as an outflow of cash.
- ₹ 110,000 a charge to Profit and Loss Account is non-cash expense and would be added back to the reported net income (profit)

Illustration 7

The following information is given to you about the provision for taxation of M/s Gill India (Pvt) Limited.

Liabilities	*March 31, 2013* ₹	*March 31, 2014* ₹
Provision for taxation	15000	20000

Net Income for the year 2013-14 is ₹ 50,000

How would you deal with this item assuming it as non-current liability?

Solution

Provision for the year 2012-13 is an outflow of cash.

Provision for the 2013-14 shall be dealt with as follows

	₹
Net Income for the 2013-14	50,000
Add provision for Taxation for 2013-14	20000
Cash provided from operating activities	70,000

Illustration 8

The following relevant Information is obtained from the book of Venugopalan Limited.

Liabilities	*March 31, 2013* ₹	*March 31, 2014* ₹
Provision for Taxation	50,000	70,000

The amount of tax paid during 2013-14 amounted to ₹ 40000. How would you deal with this item presuming to be non current? You are also given net profit after taxation was ₹ 80000.

Solution

To solve this problem, one should find out the amount of provision for tax charged to Statement of Profit & Loss for the year 2013-14.

Provision for Taxation Account

Dr Cr

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Bank (payment)	40,000	Balance b/d	50,000
Balance c/d	70,000	Statement of Profit and loss (Balances Figure)	60,000
	1,10,000		1,10,000

(i) loss 40000 is an outflow of cash

(ii) Cash provided from operating activities will be calculated as

Net Income after taxation	80,000
Add: Provision for taxation treated as non-cash expense	60,000
	1,40,000

Illustration 9

The following comparative balance sheets contain the relevant information about provision for taxation.

Liabilities	*March 31, 2013* ₹	*March 31, 2014* ₹
Provision for Taxation	20,000	30,000

You are informed that Provision for Taxation ₹ 50,000 was charged to Statement of profit and Loss for the year 2013-14. Ascertain the cash used.

Solution

Provision for Taxation Account

Dr Cr

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
Bank (Balancing figure)	40,000	Balance b/d	20,000
Balance c/d	30,000	Statement of Profit and Loss	50,000
	70,000		70,000

Note :

- ₹ 40,000 would be shown as an outflow of cash
- ₹ 50,000 would be treated as non cash expense and added back to net Income figure to compute cash provided from operations.

Illustration 10

From the summarised cash account of ABC Limited prepare cash flow statement for the year ended 31st December 2013 in accordance with AS-3 (Revised) using the direct method and indirect method. The company does not have any cash equivalents:

Summarised Cash A/c

Particulars	*Amount (₹ 000)*	*Particulars*	*Amount (₹ 000)*
Balance on 1.1.2013	50	Payment to Suppliers	2,000

Issue of equity shares	300	Purchase of fixed assets	200
Receipts from customers	2,800	Overhead expenses	200
Sale of fixed assets	100	Wages and salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.12.2013	150
	3,250		3,250

Additional Information : Net profit before tax for the year 2013 was ₹ 500000.

Solution :

Cash Flow Statement of ABC Ltd

for the year ended 31st December 2013 (Indirect method)

	₹ 000	₹ 000
A. Cash flow from operating activities		
Net profit before tax	500	
Income tax paid	(250)	
Net cash from operating activities		250
B. Cash flow from investing activities		
Purchase of fixed assets	(200)	
Sale of fixed assets	100	
Net cash used in investing activities		(100)
C. Cash flow from financing activities :		
Issue of equity shares	300	
Repayment of bank loan	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash (A+B+C) (Net cash inflow from activities)		100
Add : Opening balance of cash		50
Closing balance of cash		150

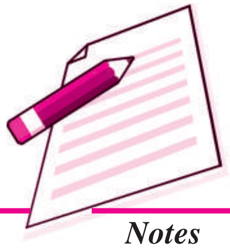


Illustration 11

Following are the Balance Sheets of *X* Ltd. Prepare Cash Flow Statement.

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital		25,00,000	20,00,000
(b) Reserves and Surplus	1	2,30,000	1,00,000
2. Current Liabilities			
Trade Payables		4,50,000	7,00,000
Total		**31,80,000**	**28,00,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets - Tangible Assets (Land)		6,60,000	5,00,000
2. Current Assets			
(a) Inventories		9,00,000	8,00,000
(b) Trade Receivables		11,50,000	12,00,000
(c) Cash and Cash Equivalents		4,70,000	3,00,000
Total		**31,80,000**	**28,00,000**

Note to Accounts

Particulars	*31st March, 2014 (₹)*	*31st March, 2014 (₹)*
1. Reserves and Surplus		
Surplus, *i.e.*, Balance in Statement of Profit & Loss	2,30,000	1,00,000

Solution :

X Ltd.
Cash Flow Statement
for the year ended 31st March, 2014

Particulars	₹	₹
Cash Flow from Operating Activities		
Profit for the Year (Difference between Closing and Opening Surplus, *i.e.,* Balance in Statement of Profit and Loss) (₹ 2,30,000 - ₹ 1,00,000)	1,30,000	
Add : Decrease in Current Asset and Increase in Current Liabilities :		
Decrease in Trade Receivables	50,000	
	1,80,000	

Less : Increase in Current Asset and Decrease in Current Liabilities :			
Increase in Inventories	(1,00,000)		
Decrease in Trade Payables	(2,50,000)	(3,50,000)	
Cash Used in Operating Activities			(1,70,000)
Cash Flow from Investing Activities			
Cash Payment for Land Purchased		(1,60,000)	
Cash Used in Investing Activities			(1,60,000)
Cash Flow from Financing Activities			
Cash Proceeds from Issue of Shares		5,00,000	
Cash Flow from Financing Activities			5,00,000
Net Increase in Cash and Cash Equivalents			1,70,000
Add: Cash and Cash Equivalents in the Beginning			3,00,000
Cash and Cash Equivalents at the End			4,70,000

Illustration 12

Prepare Cash Flow Statement on the basis of the information given in the Balance Sheet of P.S. Ltd. as at 31st March, 2014 and 31st March, 2013 :

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital		2,50,000	2,00,000
(b) Reserves and Surplus	1	70,000	50,000
2. Non-Current Liabilities			
Long-term Borrowings (12% Debentures)		80,000	1,00,000
3. Current Liabilities			
(a) Trade Payables	2	1,60,000	60,000
(b) Other Current Liabilities (Outstanding Liabilities)		20,000	25,000
Total		**5,80,000**	**4,35,000**
II. ASSETS			
1. Non-Current Assets			
(a) *Fixed Assets :*			
(i) Tangible Assets :Land and Building		2,80,000	2,00,000
(ii) Intangible Assets : Patents		2,000	10,000

Notes

(b) Long-term Loans and Advances		1,30,000	1,00,000
2. Current Assets			
(a) Current Investment		5,000	3,000
(b) Inventories		90,000	70,000
(c) Trade Receivables		60,000	40,000
(d) Cash and Cash Equivalents		13,000	12,000
Total		**5,80,000**	**4,35,000**

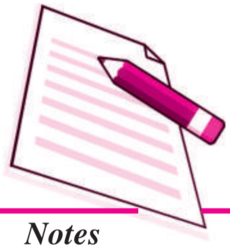
Note to Accounts

Particulars	*31st March, 2014 (₹)*	*31st March, 2014 (₹)*
1. Reserves and Surplus		
Surplus, *i.e.*, Balance in Statement of Profit & Loss	70,000	50,000
2. Trade Payables		
Creditors	60,000	40,000
Bills Payable	1,00,000	20,000
	1,60,000	60,000

Solution :

P.S. Ltd.
Cash Flow Statement
for the year ended 31st March, 2014

Particulars		₹
I. Cash Flow from Operating Activities		
Closing Balance of Surplus, *i.e.*, Balance in Statement of Profit and Loss		70,000
Less: Opening Balance of Surplus, *i.e.*, Balance in Statement of Profit and Loss		(50,000)
Net Profit before Tax and Extraordinary Items		20,000
Add : Non-cash Expenses : Patents Amortised	8,000	
Non-operating Expenses : Interest on Long'term Loans*	12,000	20,000
Operating Profit before Working Capital Changes		40,000
Add : *Increase in Current Liabilities :*		
Increase in Creditors	20,000	
Increase in Bills Payable	80,000	1,00,000
		1,40,000



Notes

Less : *Increase in Current Asset and Decrease in Current Liabilities :*		
Decrease in Outstanding Expenses	(5,000)	
Increase in Trade Receivables	(20,000)	
Increase in Inventories	(20,000)	(45,000)
Cash Flow from Operating Activities (I)		95,000
II. Cash-Flow from Investing Activities		
Purchase of Land and Building		(80,000)
Loans and Advances		(30,000)
Cash Used in Investing Activities (II)		(1,10,000)
III. Cash Flow from Financing Activities		
Proceeds from Issue of Equity Shares		50,000
Repayment of Long-term Borrowings		(20,000)
Interest on Long-term Loans		(12,000)
Cash Inflow from Financing Activities (III)		18,000
IV. Net Increase in Cash and Cash Equivalents (I + II + III)		**3,000**
V. Cash and Cash Equivalents in the beginning of the year (₹.3,000 + ₹ 12,000)		**15,000**
VI. Cash and Cash Equivalents at the end of the year (IV + V) (₹ 5,000 + ₹ 13,000)		**18,000**

* Debenture interest @ 12% on ₹ 1,00,000.

Limitations of cash flow statement

Though it is true that cash flow statement is very useful now-a-days and serves many purposes. But it is necessary to take certain precautions while making use of this important tool. The reason is that misleading conclusions might be found by not properly relating net income figure to the cash flow. Some of the significant limitations of Cash Flow Statement are given below:

- It is very difficult to precisely define the term ‘cash’
- There are controversies over a number of items like cheques, stamps, postal orders etc. to be included in cash or not.
- As the present business moves from the cash basis to accrual basis, the prepaid and credit transactions might be represented an increase in working capital and it would be misleading to equate net income to cash flow because a number of non cash items would affect the net income.

INTEXT QUESTIONS 34.4

Fill in the blanks with suitable word/words :

(i) Provision for taxation is .... expenses.

(ii) Increase in share capital is ....

(iii) purchase of fixed assets is ....

(iv) Redemption of debentures is ....

(v) Sale of fixed assets is ....

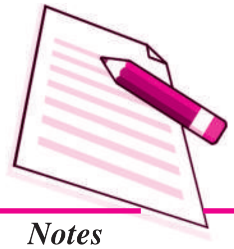
(vi) Issue of debentures is ....

WHAT YOU HAVE LEARNT

- Cash flow statement deals with flow of cash which includes cash equivalent as well as cash.
- Cash flow statement is a summary of cash receipts and disbursements during a certain period.
- Cash flow statement is prepared as per AS-3 (Revised).
- Cash flow statement shows three categories of cash inflows and outflows i.e. (i) Operating activities (ii) Investing activities (iii) Financing activities
- Operating activities are the revenue generating activities of the enterprise.
- Investing activities constitute the acquisition and disposal of long term assets and other investments not included in cash and equivalents.
- Financing activities are activities that result in change in the size and composition of the share capital and borrowings of the enterprise.
- The cash flows from extraordinary items are to be stated separately as arising from operating, investing and financing activities.

TERMINAL EXERCISE

1. What do you mean by Cash Flow Statement? State main objectives of cash flow statement.
2. Define cash as per AS-3 (revised). How the various activities are classified as per AS-3 revised while preparing cash flow statement.



Notes

3. Give three examples of operating activities.

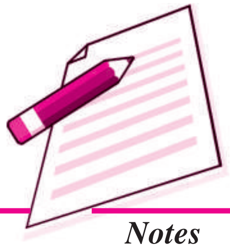
4. Give two examples of investing activities.

5. From the following Balance Sheets of *X* Ltd., prepare Cash Flow Statement:

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital	1	2,00,000	1,80,000
(b) Reserves and Surplus	2	6,400	6,000
2. Non-Current Liabilities			
Long-term Borrowings :			
10% Debentures		14,000	12,000
3. Current Liabilities			
(a) Short-term Borrowing			
(Bank Overdraft)		13,600	25,000
(b) Trade Payables (Creditors)		22,000	24,000
(c) Short-term Provisions	3	20,000	16,000
Total		**2,76,000**	**2,63,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets	4	1,50,000	1,60,000
2. Current Assets			
(a) Trade Receivables		48,000	40,000
(b) Inventories		71,000	60,600
(c) Cash and Cash Equivalents		7,000	2,400
Total		**2,76,000**	**2,63,000**

Notes to Accounts

Particulars	*31 March, 2014 (₹)*	*31 March, 2013 (₹)*
1. Share Capital		
Share Capital	1,80,000	1,55,000
10% Preference Share Capital	20,000	25,000
	2,00,000	1,80,000



Notes

2. Reserves and Surplus		
General Reserve	4,000	4,000
Surplus *i.e.*, Balance in Statement of Profit & Loss	2,400	2,000
	6,400	6,000
3. Short-term Provisions		
Provision for tax	8,000	5,000
Proposed Dividend	12,000	11,000
	20,000	16,000
4. Fixed Assets		
Cost	1,80,000	1,82,000
Less : Accumulated Depreciation	30,000	22,000
	1,50,000	1,60,000

6. From the following Balance Sheets of Human Kind Pharamacticuals Ltd.

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital	1	2,90,000	2,50,000
(b) Reserves and Surplus	2	72,000	50,000
2. Current Liabilities			
Trade Payables		5,000	23,000
Total		**3,67,000**	**3,23,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets :			
(a) Tangible	3	1,50,000	1,40,000
(b) Intangible (Goodwill)		20,000	30,000
2. Current Assets			
(a) Trade Receivables		1,60,000	1,20,000
(b) Inventories		20,000	18,000
(c) Cash		17,000	15,000
Total		3,67,000	3,23,000

Notes to Accounts

Particulars	31st March, 2014 (₹)	31st March, 2013 (₹)
1. Share Capital		
Equity Share Capital	2,40,000	2,00,000
12% Preference Share Capital	50,000	50,000
	2,90,000	2,50,000
2. Reserves and Surplus		
General Reserve	50,000	35,000
Surplus, *i.e.,* Balance in Statement of Profit & Loss	22,000	15,000
3. Fixed Assets (Tangible)		
Building	80,000	1,00,000
Plant	70,000	40,000
	1,50,000	1,40,000

7. From the following Balance Sheets Kamni Medical College & research Centre Ltd. as at 31st March, 2014 and 31st March, 2013, prepare Cash Flow Statement :

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital	1	16,00,000	10,40,000
(b) Reserves and Surplus	2	5,50,000	2,60,000
2. Non-Current Liabilities			
Long-term Borrowings:			
9% Debentures		4,00,000	6,00,000
3. Current Liabilities			
Trade Payables		4,50,000	1,00,000
Total		**30,00,000**	**20,00,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets		20,00,000	15,00,000
2. Current Assets			
(a) Inventories		3,00,000	2,00,000
(b) Trade Receivables		2,00,000	1,00,000
(c) Cash and Cash Equivalents		5,00,000	2,00,000

Notes

Notes to Accounts

Particulars	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
1. Share Capital		
Equity Share Capital	15,00,000	10,00,000
7% Preference Share Capital	1,00,000	40,000
	16,00,000	10,40,000
2. Reserves and Surplus		
Surplus, *i.e.,* Balance in Statement of P & L	1,50,000	2,00,000
General Reserve	4,00,000	60,000
	5,50,000	2,60,000

Additional Information :

i. During the year a machinery costing ₹20,000

ii. Dividend paid ₹ 50,000.

8. From the following Balance Sheets of *X* Ltd., prepare Cash Flow Statement:

Particulars	*Note No.*	*31st March, 2014 (₹)*	*31st March, 2013 (₹)*
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital		4,00,000	3,00,000
(b) *Reserves and Surplus :* Surplus, *i.e.,* Balance in Statement of Profit & Loss		1,10,000	85,000
2. Non-Current Liabilities			
Long-term Borrowing : Bank Loan		75,000	1,00,000
3. Current Liabilities			
(a) Trade Payables (Creditors)		2,95,000	3,10,000
(b) Short-term Provisions	1	60,000	45,000
Total		9,40,000	8,40,000
II. ASSETS			
1. Non-Current Assets			
Fixed Assets (Net)	2	4,15,000	3,20,000
2. Current Assets			
(a) Inventories (Stock)		2,25,000	2,00,000
(b) Trade Receivables	3	3,00,000	2,90,000
(c) Cash and Cash Equivalents			30,000
Total		**9,40,000**	**8,40,000**

Notes to Accounts

Particulars	**31st March, 2014 (₹)**	**31st March 2013 (₹)**
1. Short-term Provisions		
Proposed Dividend	60,000	45,000
2. Fixed Assets		
Less : Accumulated Depreciation	5,50,000	4,00,000
3. Trade Receivables		
Debtors	1,90,000	2,10,000
Bills Receivable	1,10,000	80,000
	3,00,000	2,90,000

Additional Information :

A piece of machinery costing ₹ 60,000 on which accumulated depreciation was ₹ 15,000 was sold for ₹ 30,000.

9. The Balance Sheets of Virendra Paper Ltd. as at 31st March, 2014 and 2013 are given below :

Particulars	***Note No.***	***31st March, 2014 (₹)***	***31st March 2013 (₹)***
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
(a) Share Capital		7,20,000	6,00,000
(b) *Reserves and Surplus :* Surpluse, *i.e.,* Balance in Statement of Profit & Loss		4,80,000	3,75,000
2. Non-Current Liabilities			
Long-term Borrowing :			
10% Debentures		2,70,000	4,50,000
3. Current Liabilities			
Trade Payables		1,20,000	90,000
Total		**15,90,000**	**15,15,000**
II. ASSETS			
1. Non-Current Assets			
Fixed Assets	1	7,50,000	7,20,000
2. Current Assets			
(a) Trade Receivables		3,00,000	2,25,000
(b) Inventories		3,60,000	4,20,000
(c) Cash and Cash Equivalents		1,80,000	1,50,000
Total		**15,90,000**	**15,15,000**

Notes to Accounts

Particulars			31st March, 2014 (₹)	31st March 2013 (₹)
1. Fixed Assets				
Land			2,40,000	3,00,000
	2014 (₹)	*2013 (₹)*		
Plant and Machinery	7,50,000	6,00,000		
Less: Accumulated Depreciation	2,40,000	1,80,000		
	5,10,000	4,20,000	5,10,000	4,20,000
			7,50,000	7,20,000

Additional Information :

i. Interim Dividend of ₹ 75,000 has been paid during the year.

ii. Debenture Interest paid during the year ₹ 27,000.

You are required to prepare Cash Flow Statement.

Notes

ANSWERS TO INTEXT QUESTIONS

34.1 (i) Cash equivalents (ii) financial
(iii) Cash inflow, cash outflow (iv) Cash equivalent

34.2 (i) listed (ii) investing

34.3 (i) Operating activities (ii) Financing activities
(iii) Investing activities (iv) Investing activities
(v) Financing activities

34.4 (i) Non operating (ii) Cash inflow (iii) Cash outflow
(iv) Cash outflow (v) Cash inflow (vi) Cash inflow

ACTIVITY

Visit the office of a joint stock company and study the cash flow statement prepared by the company. Prepare a list of already possible items (two each) that may increase and decrease the fund from

(a) Operating activities (b) Investing activities (c) Financing activities

14

ELECTRONIC SPREAD SHEET

Now a days accounting transactions are processed through computers. Usage of computers enables a business to quickly, accurately and timely access the information that helps in decision-making. This sharpens the competitive edge and enhances profitability of the business. The computer systems work with the data which is processed by the hardware commanded by the user through software. The Computerised Accounting System (CAS) has the following components:

Procedure : A logical sequence of actions to perform a task.

Data : The raw fact (as input) for any business application.

People : Users.

Hardware : Computer, associated peripherals, and their network.

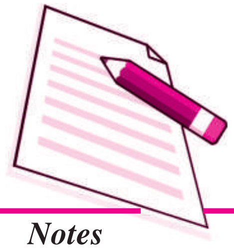
Software : System software and Application software.

These are the five pillars on which Computerised Accounting System rests. This Lesson discusses about the Electronic Spread Sheet, which is used in computers as special software for processing and generating the various types of data. Electronic Spread Sheet is also known as Worksheet. In this Lesson, we will discuss the meaning, features and other related terms and procedures related to Electronic Spread Sheet.

OBJECTIVES

After studying this Lesson, you will be able to:

- State the meaning of Electronic Spread Sheet.
- Explain the features of Electronic Spread Sheet
- Explain the procedure of Data entry, Text Management and Cell formatting in Excel.



Notes

- Explain the procedure of calculations in Excel.
- Explain the procedure of preparation of Various Reports through Excel.

35.1 MEANING OF ELECTRONIC SPREADSHEET

Electronic Spreadsheet is a combination of rows and columns. Visually, the spreadsheet looks like any other matrix with rows and columns. It is also known as a worksheet. This worksheet is so large that the human eye cannot view all its rows and columns at a point of time. Therefore, user focuses on few rows and columns and keeps changing the focus to the required part of the worksheet, as and when required. It is normally used for calculations and comparison of numerical or financial data for arriving at the desired information for reporting. An electronic spreadsheet is a computer program that allows the user to add and process data. The concept of electronic spreadsheet can well be understood with the help of MS Excel, which is one of the MS office software.

35.2 BASICS AND FEATURES OF SPREADSHEET

A spreadsheet is characterized by certain features, given as under:

1. **Grid :** By definition, a spreadsheet is seen as grid structured by number of rows and columns. Each row is sequentially assigned number such as 1,2,3…. And every column is assigned an alphabet for identification. First 26 columns are assigned alphabets beginning A to Z and thereafter, the columns begins with AA followed by AB till the last column is assigned alphabets.

2. **Element :** Each element of spreadsheet is defined by a point of intersection between a particular row and column. It is therefore, addressed by referring to the relevant row and column. For example, the element A1 means the first row of column A. The element is capable of storing data and formulae for calculations.

3. **Lens View :** Spreadsheet allows the user to view and concentrate on a limited number of rows and columns to work with.

4. **Functions :** Spreadsheet is supported by a large number of functions capable of performing difficult and lengthy calculations in fractions of seconds.

5. **Formatting :** Spreadsheet has text formatting capabilities. This enables the generated report to be saved, printed and exported to other applications for use.

6. **Save, Print and Export :** Spreadsheet is saved as a file so that it can be opened for additions and alterations as per the need arisen. It can also be printed by selecting a part of the entire sheet. It can also be sent to mail recipient as an attachment.

Notes

INTEXT QUESTIONS 35.1

Fill in the blanks with suitable word/words:

i. A spreadsheet is seen as ___________ structured by number of rows and columns.

ii. Each element of spreadsheet is a point of ___________ between a particular row and column.

iii. Spreadsheet allows the user to view and concentrate on a limited number of ___________ and ___________ to work with.

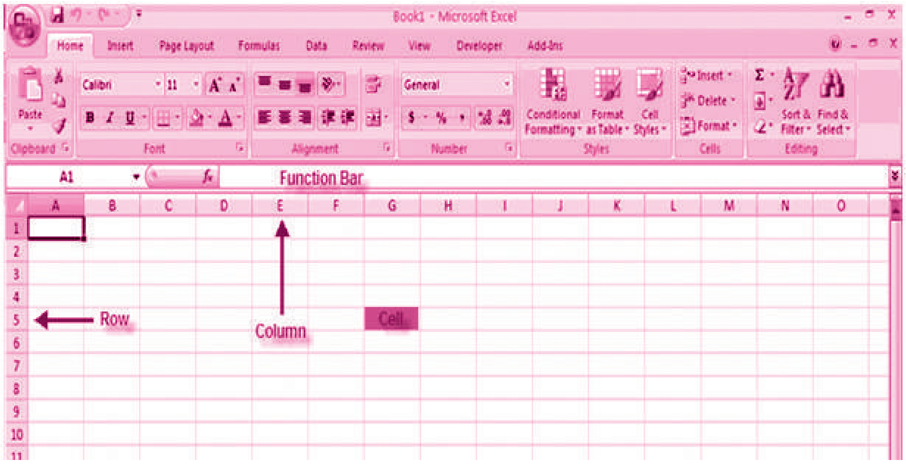
iv. Spreadsheet is supported by a large number of ___________ for difficulty and lengthy calculations in fraction of seconds.

v. A saved spreadsheet can be opened for additions and ___________.

35.3 DATA ENTRY, TEXT MANAGEMENT AND CELL FORMATTING

Excel is one of the software that is bundled with MS office to implement the spreadsheet described above. Here under, we are exhibiting the visuals using MS Excel 2007. Basic features offered by MS Excel are:

1. **Workbook and Worksheet in Excel :** Spreadsheet is referred to as a worksheet in Excel. This worksheet is a single page of a workbook which is a multipage document. At a time, only one worksheet is available to a user for carrying out operations. When an excel program is executed, a new excel workbook is opened along with Excel application window shown below:



As already stated a spreadsheet is an electronic document that stores various types of data. There are vertical columns and horizontal rows. A cell is where the column and row intersect. A cell can contain data and can be used in calculations of data

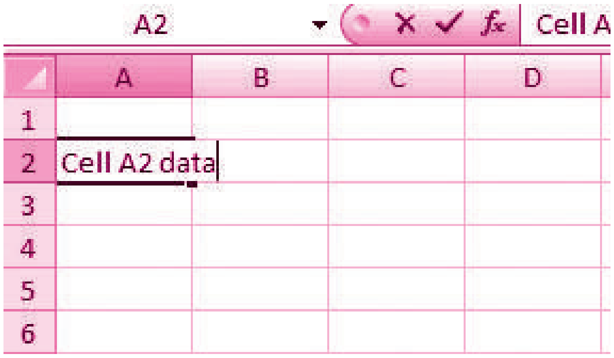
within the spreadsheet. An Excel spreadsheet can contain workbooks and worksheets. The workbook is the holder for related worksheets.

2. **Worksheet Operations :** The following worksheet operations are associated with the spread sheet:

i. ***Movement of Cell Pointer :*** To activate a cell pointer, click at the cell. The cell pointer is moved from its current location to another by using arrow keys: left, right, up and down. By keeping the **ctrl key** pressed, the use of arrow keys moves the cell pointer to the edge of current data region that is defined as an area of worksheet with data entered in cells and bounded by the edges of the worksheet and its empty rows and columns.

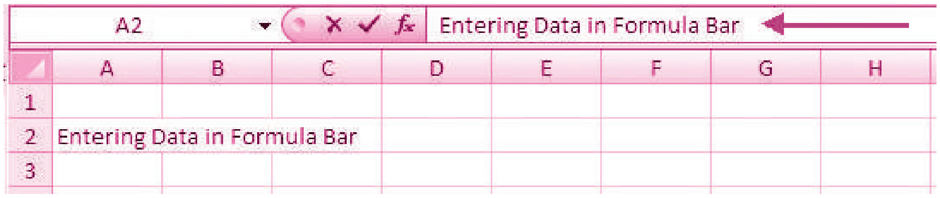
ii. ***Short-Cut Menu :*** It is called by a **right click** action of the mouse on selected cells so as to perform various operations. The short-cut menu is handy tool because it includes list of those operations that are commonly performed on selected cells.

iii. ***Entering Data into Cells :*** There are different ways to enter data in Excel: in an active cell or in the formula bar. To enter data in an active cell:

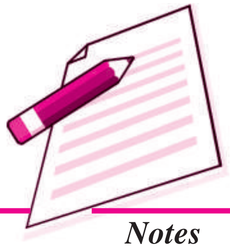


- Click in the **cell** where you want the data
- Begin typing

To enter data into the **formula bar**



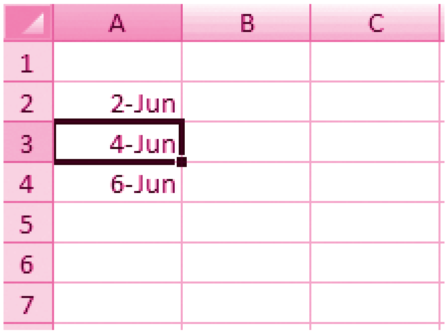
- Click the cell where you would like the data
- Place the cursor in the **Formula Bar**
- Type in the data



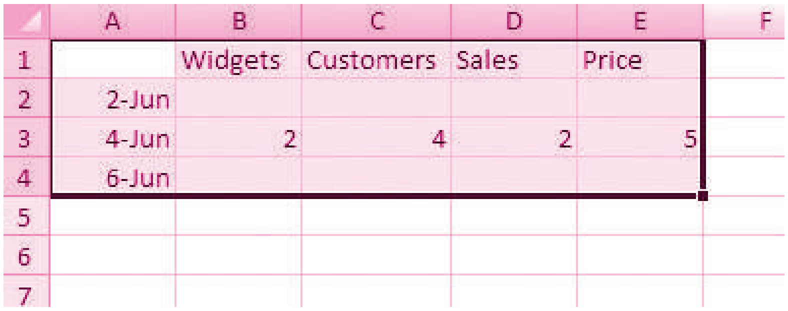
Notes

iv. ***Selecting Multiple Cells:*** Excel allows you to move, copy, and paste cells and cell content through cutting & pasting and copying & pasting.

- To select a cell or data to be copied or cut: Click the **cell**



- Click and drag the cursor to select many cells in a range

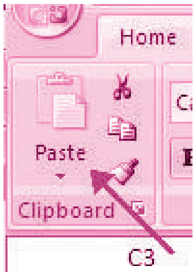


Select a Row or Column

To select a row or column click on the **row** or **column header**.

Copy and Paste

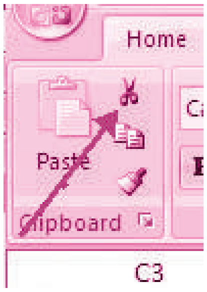
To copy and paste data:



- Select the cell(s) that you wish to copy
- On the **Clipboard** group of the **Home** tab, click **Copy**
- Select the cell(s) where you would like to copy the data
- On the **Clipboard** group of the **Home** tab, click **Paste**

Cut and Paste

To cut and paste data:



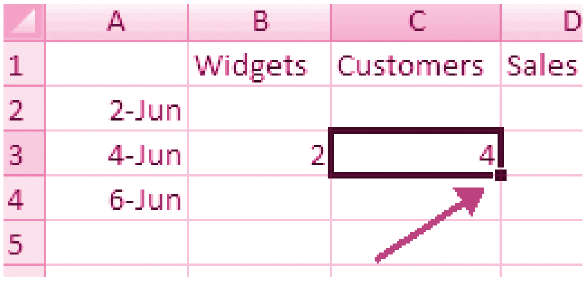
- Select the cell(s) that you wish to copy
- On the **Clipboard** group of the **Home** tab, click **Cut**
- Select the cell(s) where you would like to copy the data
- On the **Clipboard** group of the **Home** tab, click **Paste**

Undo and Redo

To undo or redo you're most recent actions:

- On the **Quick Access Toolbar**
- Click **Undo** or **Redo**

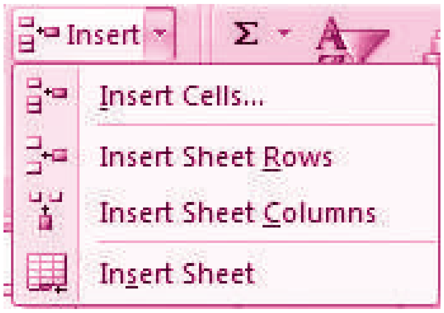
Auto Fill : The Auto Fill feature fills cell data or series of data in a worksheet into a selected range of cells. If you want the same data copied into the other cells, you only need to complete one cell. If you want to have a series of data (for example, days of the week) fill in the first two cells in the series and then use the auto fill feature. To use the Auto Fill feature:



- Click the **Fill Handle**
- **Drag** the **Fill Handle** to complete the cells

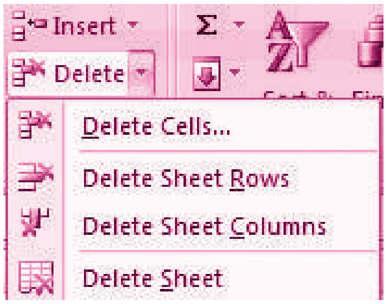
Insert Cells, Rows, and Columns

To insert cells, rows, and columns in Excel:



- Place the cursor in the row below where you want the new row, or in the column to the left of where you want the new column.
- Click the **Insert** button on the **Cells** group of the **Home** tab
- Click the appropriate choice: **Cell, Row, or Column**

Delete Cells, Rows and Columns



To delete cells, rows, and columns:

- Place the cursor in the cell, row, or column that you want to delete
- Click the **Delete** button on the **Cells** group of the **Home** tab
- Click the appropriate choice: **Cell, Row, or Column**

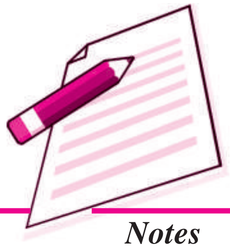
v. ***Managing Text in Excel :*** For any business organization using electronic spread sheet the basic requirement is to input data. The data can be input via fresh data entry as explained above or it can be transferred from other applications. **Importing Data from other sources** is easier to import data or transfer files to Excel worksheet. These data files may in other text files or non text files format.

Text files can be directly read using a text editor such as Note Pad in MS Windows. These files often have extension *.txt* but can have other extensions (such as .csv known as **C**oma **S**eparated **V**alues text file). In order to import data from a text file, following steps are considered:

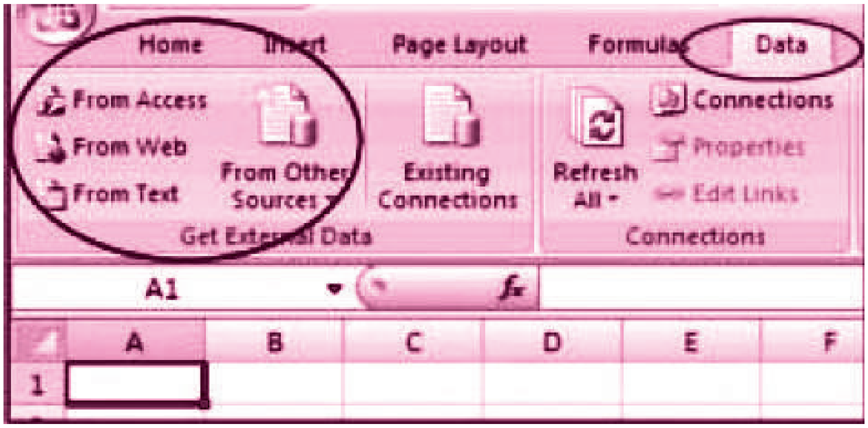
1. Create data file using Note pad program of MS Windows (to get Note pad screen on desktop on Start button->All Programs->Accessories -> Notepad)
2. A comma-separated data values in one line of this text file is a row in a spread sheet and each entry separated by a comma, is column entry for that row as shown below:

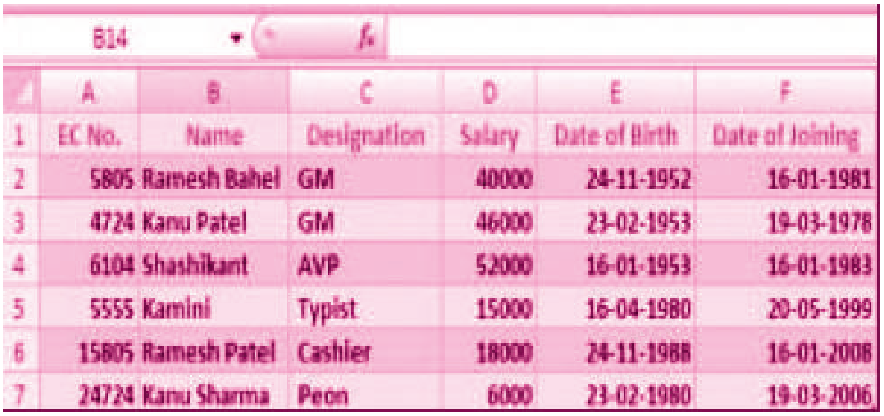
empdata - Notepad
File Edit Format View Help
EC No.,Name,Designation,Salary,Date of Birth,Date of Joining
05805,Ramesh Bahel, GM,40000.00,24-11-1952,16-01-1981
04724,Kanu Patel, GM,46000.00,23-02-1953,19-03-1978
06104,Shashikant, AVP, 52000.00, 16-01-1953, 16-01-1983
05555,Kamini, Typist, 15000.00,16-04-1980,20-05-1999
15805,Ramesh Patel, Cashier,18000.00,24-11-1988,16-01-2008
24724,Kanu Sharma, Peon,6000.00,23-02-1980,19-03-2006

3. In the first line provide names for the columns of the spread sheet.
4. In the next line onward start entering the data separate by comma as per the names given in first line.
5. It may be possible that every data may not be of similar length but each data (even a blank data) should be separated by comma as per the names of the column.
6. Open a new Excel worksheet from the office button.
7. Select Data Tab on the Ribbon.
8. On the Data Tab; an option Get External Data having From Text option.
9. Click on ‘ From Text’ which will allow selecting a Note pad file saved as .cvm into Excel format directly and data copied into respective columns and rows as shown below:



Notes





B14

	A	B	C	D	E	F
1	EC No.	Name	Designation	Salary	Date of Birth	Date of Joining
2	5805	Ramesh Bahel	GM	40000	24-11-1952	16-01-1981
3	4724	Kanu Patel	GM	46000	23-02-1953	19-03-1978
4	6104	Shashikant	AVP	52000	16-01-1953	16-01-1983
5	5555	Kamini	Typist	15000	16-04-1980	20-05-1999
6	15805	Ramesh Patel	Cashier	18000	24-11-1988	16-01-2008
7	24724	Kanu Sharma	Peon	6000	23-02-1980	19-03-2006

INTEXT QUESTIONS 35.2

Fill in the blanks with suitable word/words:

i. A cell is where the row and column ___________.

ii. The cell pointer is moved from its current location to another by using __________ keys.

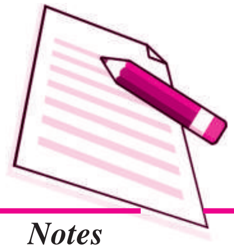
iii. The short-cut-menu is __________ tool for the operations that are __________ performed on selected cells.

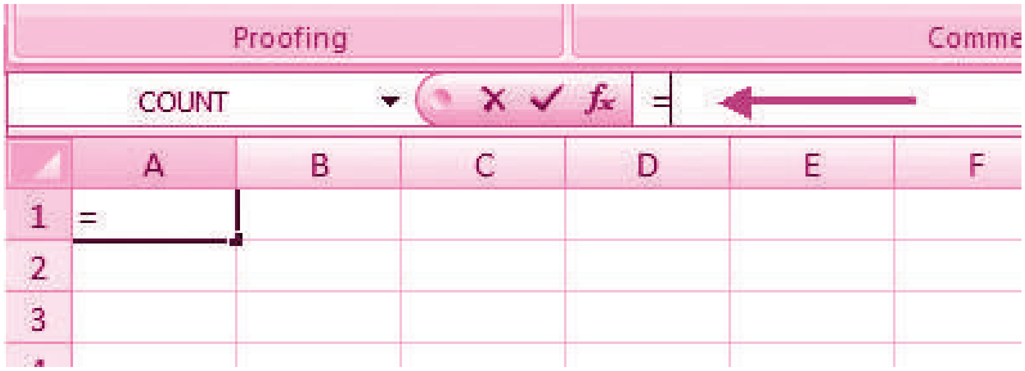
iv. To enter data in an active __________, click in the __________ where you want the data and start typing.

v. Click and __________ the cursor to select many cells in a range.

35.4 PERFORMING CALCULATIONS IN EXCEL

A formula is a set of mathematical instructions that can be used in Excel to perform calculations. Formulas start in the formula box with an = sign.





There are many elements to excel formula.

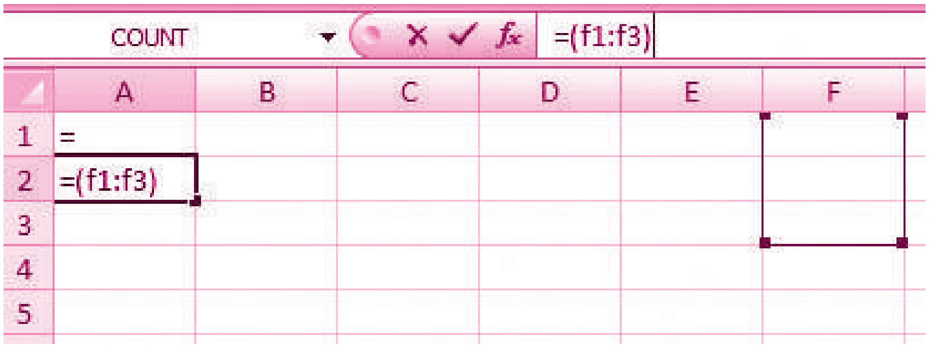
References : The cell or range of cells that you want to use in your calculation.

Operators : Symbols (+, -, *, /, etc.) that specify the calculation to be performed

Constants : Numbers or text values that do not change.

Functions : Predefined formulas in Excel.

To create a basic formula in Excel :



- Select the **cell** for the formula
- Type = (the equal sign) and the **formula**
- Click **Enter**

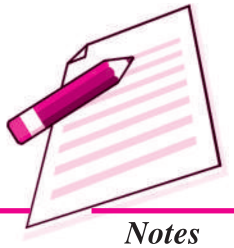
35.4.1 Calculate with Functions

A function is a built in formula in Excel. A function has a name and arguments (the mathematical function) in parentheses. Common functions in Excel:

Sum : Adds all cells in the argument

Average : Calculates the average of the cells in the argument

Min : Finds the minimum value

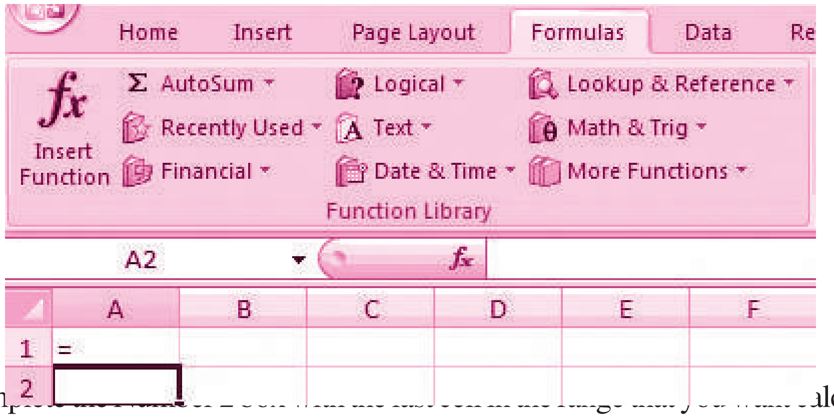


Max : Finds the maximum value

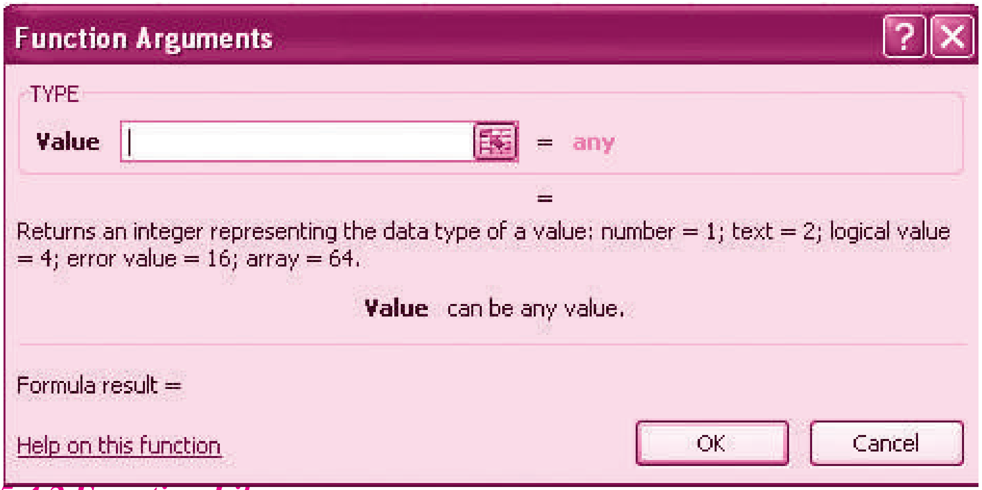
Count : Finds the number of cells that contain a numerical value within a range of the argument

To calculate a function:

- Click the **cell** where you want the function applied
- Click the **Insert Function** button
- Choose the function
- Click **OK**
- Complete the Number 1 box with the first cell in the range that you want to calculate



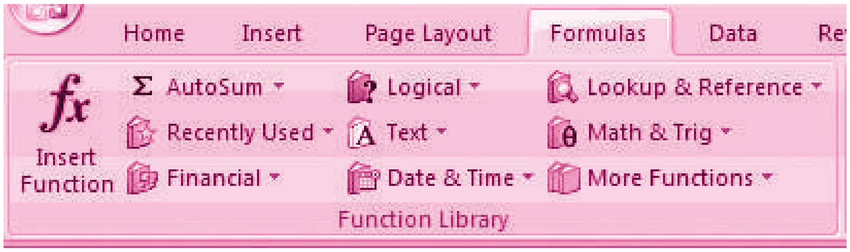
- Com… alculated



35.4.2 Function Library

The function library is a large group of functions on the Formula Tab of the Ribbon. These functions include:

AutoSum	:	Easily calculates the sum of a range
Recently Used	:	All recently used functions
Financial	:	Accrued interest, cash flow return rates and additional financial functions
Logical	:	And, If, True, False, etc.
Text	:	Text based functions
Date & Time	:	Functions calculated on date and time
Math & Trig	:	Mathematical Functions



35.4.3 Relative, Absolute and Mixed References

Calling cells by just their column and row labels (such as "A1") is called **relative referencing**.

When a formula contains relative referencing and it is copied from one cell to another, Excel does not create an exact copy of the formula. It will change cell addresses relative to the row and column they are moved to. For example, if a simple addition formula in cell C1 "=(A1+B1)" is copied to cell C2, the formula would change to "=(A2+B2)" to reflect the new row.

To prevent this change, cells must be called by **absolute referencing** and this is accomplished by placing dollar signs "$" within the cell addresses in the formula. Continuing the previous example, the formula in cell C1 would read "=($A$1+$B$1)" if the value of cell C2 should be the sum of cells A1 and B1. Both the column and row of both cells are absolute and will not change when copied.

Mixed referencing can also be used where only the row OR column fixed. For example, in the formula "=(A$1+$B2)", the row of cell A1 is fixed and the column of cell B2 is fixed.

Linking Worksheets

You may want to use the value from a cell in another worksheet within the same workbook in a formula. For example, the value of cell A1 in the current worksheet and cell A2 in the second worksheet can be added using the format "sheetname!celladdress". The formula for this example would be "=A1+Sheet2!A2" where the value of cell A1 in the current worksheet is added to the value of cell A2 in the worksheet named "Sheet2".

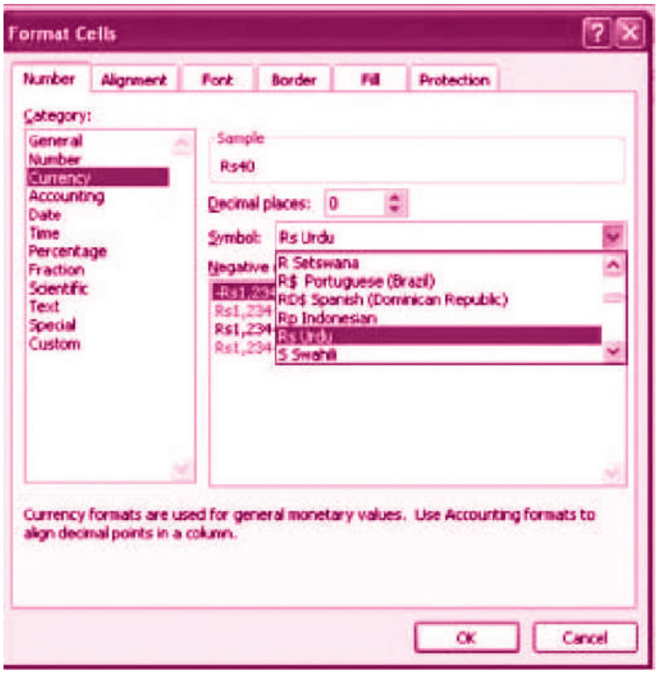
35.4.4 Data Formatting

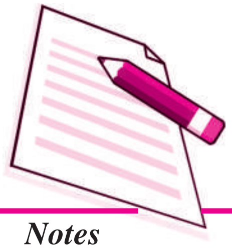
Formatting of spread sheet makes easier to read and understand the important information. This is chiefly categorized as follows:

1. ***Number formatting :*** Number formatting includes adding per cent (%), Comma (,), decimal (.), currency (Rs., $), date, time, scientific values etc. Refer figure 1 given below which depicts the unformatted worksheet:

	A	B	C	D	E	F	G	H
1	Sales for Home AppliancesYear 2008_09							
2	(Figures in 000's)							
3		Q1	Q2	Q3	Q4	Actual	Target	In %
4	ALOK	40	57	52	65	214	250	0.856
5	PRANAV	50	69	69	90	278	220	1.2636
6	PRABODH	53	75	71	82	281	250	1.124
7	RAJENDRA	44	59	38	70	211	200	1.055
8	Total					984	920	1.0696
9	Reported on							
10	16.04.2009							

2. From the Ribbon select, Home Tab with Number option. Click on **Format Cells** dialog box and choose **Number** tab.





Notes

3. The **Category** list shows all the preset formulas available in Excel, grouped into categories.

4. If we select **Currency**, the right hand side shows the different symbols of currencies.

5. Change the number of decimal spaces to zero (0).

6. Click OK to accept this format. The final output is shown below:

	A	B	C	D	E	F	G	H
1	Sales for Home AppliancesYear 2008_09							
2	(Figures in 000's)							
3		Q1	Q2	Q3	Q4	Actual	Target	In %
4	ALOK	Rs.40	Rs.57	Rs.52	Rs.65	214	250	0.856
5	PRANAV	Rs.50	Rs.69	Rs.69	Rs.90	278	220	1.2636
6	PRABODH	Rs.33	Rs.75	Rs.71	Rs.82	281	250	1.124
7	RAJENDRA	Rs.44	Rs.39	Rs.38	Rs.70	211	200	1.055
8	Total					984	920	1.0696
9	Reported on							
10	16-04-2009							

	A	B	C	D	E	F	G	H
1	Sales for Home Appliances Year 2008_09							
2	(Figures in 000's)							
3		Q1	Q2	Q3	Q4	Actual	Target	In %
4	ALOK	Rs.40	Rs.57	Rs.52	Rs.65	214	250	85.60%
5	PRANAV	Rs.50	Rs.69	Rs.69	Rs.90	278	220	126.36%
6	PRABODH	Rs.53	Rs.75	Rs.71	Rs.82	281	250	112.40%
7	RAJENDRA	Rs.44	Rs.59	Rs.38	Rs.70	211	200	105.50%
8	Total					984	920	106.96%
9	Reported on							
10	16-04-2009							

INTEXT QUESTIONS 35.3

I. Name the following functions available in Excel Sheet:

i. Adds all cells in the argument.

ii. Finds the number of cells that contain a numerical value within a range of the argument.

iii. Calculates the average of the cells in the argument.

iv. Finds the maximum value.

v. Finds the minimum value.

II. Fill in the blanks with suitable word/words :

i. Calling cells by just their column and row labels is called __________.

ii. ___________ formatting includes adding, percent, comma, decimal, currency, date, time, scientific values etc.

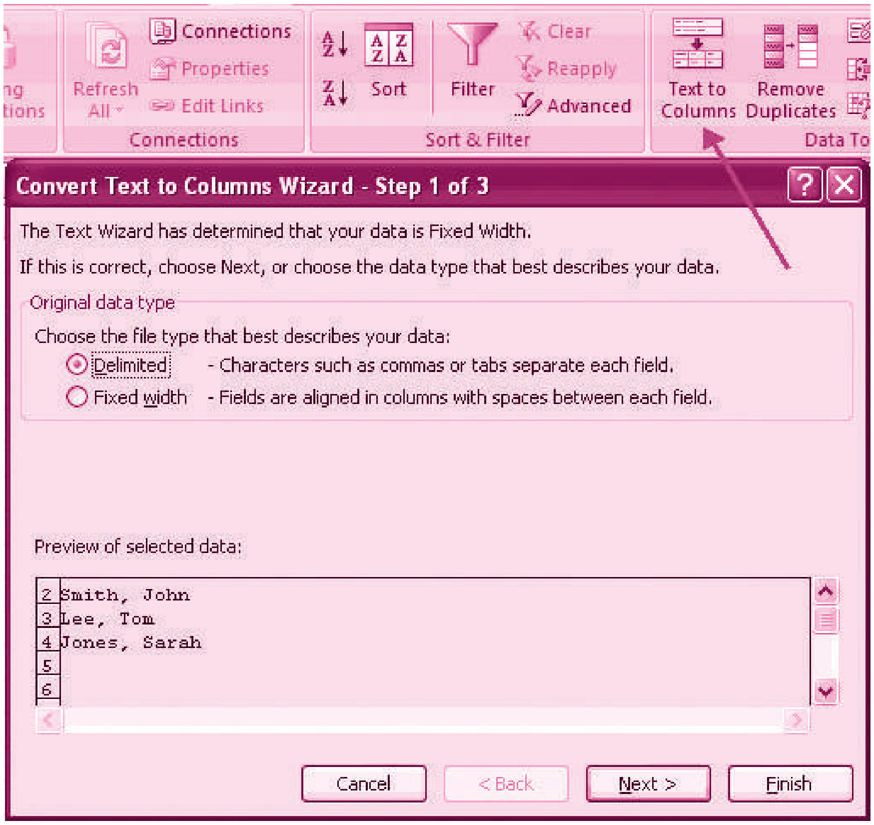
35.4.5 Text and General Formatting

Sometimes you will want to split data in one cell into two or more cells. You can do this easily by utilizing the Convert Text to Columns Wizard.

- Highlight the column in which you wish to split the data
- Click the **Text to Columns** button on the **Data** tab

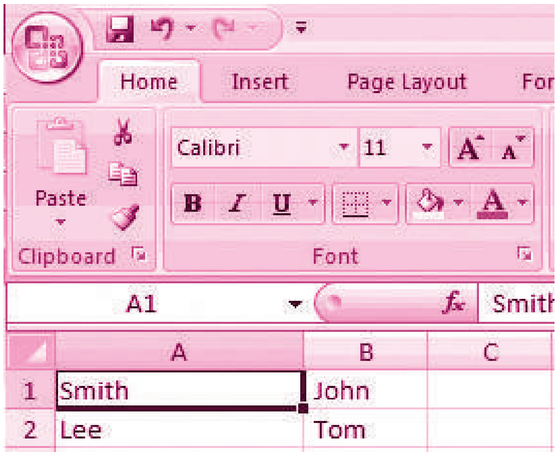
Notes

- Click **Delimited** if you have a comma or tab separating the data, or click fixed widths to set the data separation at a specific size.

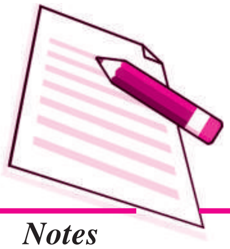


35.4.6 Modify Fonts

Modifying fonts in Excel will allow you to emphasize titles and headings. To modify a font:



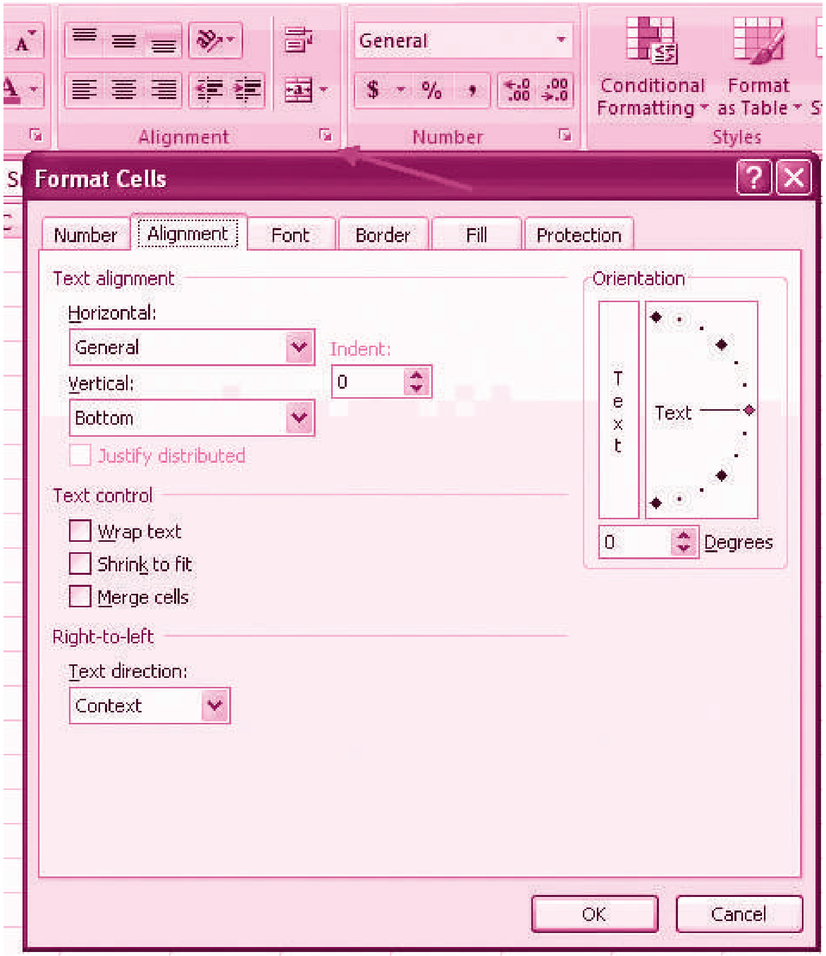
- Select the cell or cells that you would like the font applied
- On the **Font** group on the **Home** tab, choose the font type, size, bold, italics, underline, or color



Format Cells Dialog Box

In Excel, you can also apply specific formatting to a cell. To apply formatting to a cell or group of cells:

- Select the cell or cells that will have the formatting
- Click the **Dialog Box** arrow on the **Alignment** group of the **Home** tab



There are several tabs on this dialog box; that allow you to modify properties of the cell or cells.

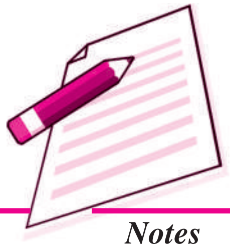
Number : Allows for the display of different number types and decimal places

Alignment : Allows for the horizontal and vertical alignment of text, wrap text, shrink text, merge cells and the direction of the text.

Font : Allows for control of font, font style, size, color, and additional features

Border : Border styles and colors

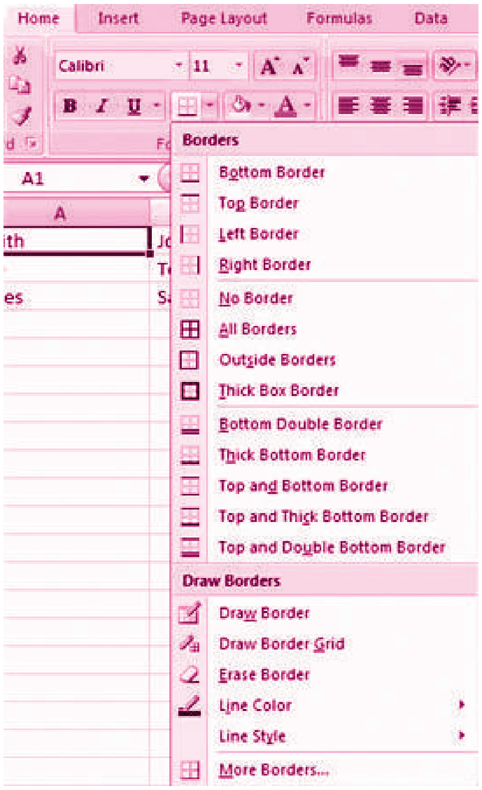
Fill : Cell fill colors and styles



Notes

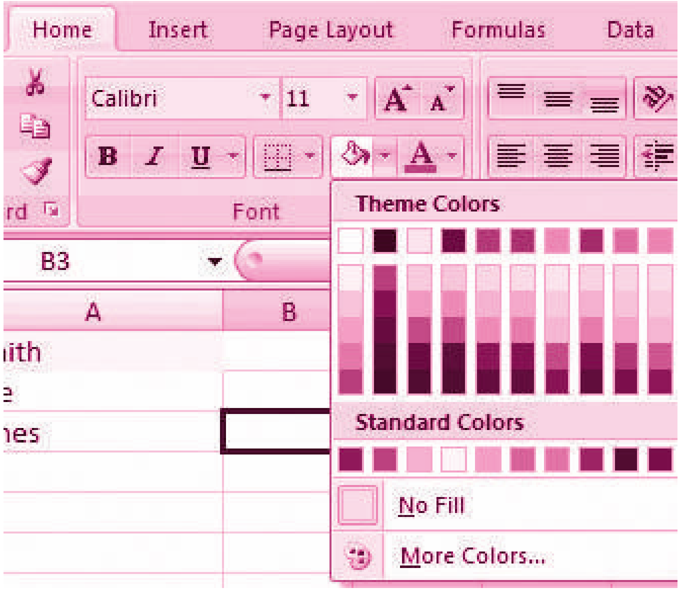
Add Borders and Colors to Cells

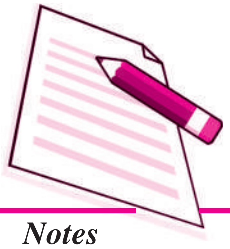
Borders and colors can be added to cells manually or through the use of styles. To add borders manually:



- Click the **Borders** drop down menu on the **Font** group of the **Home** tab
- Choose the appropriate border

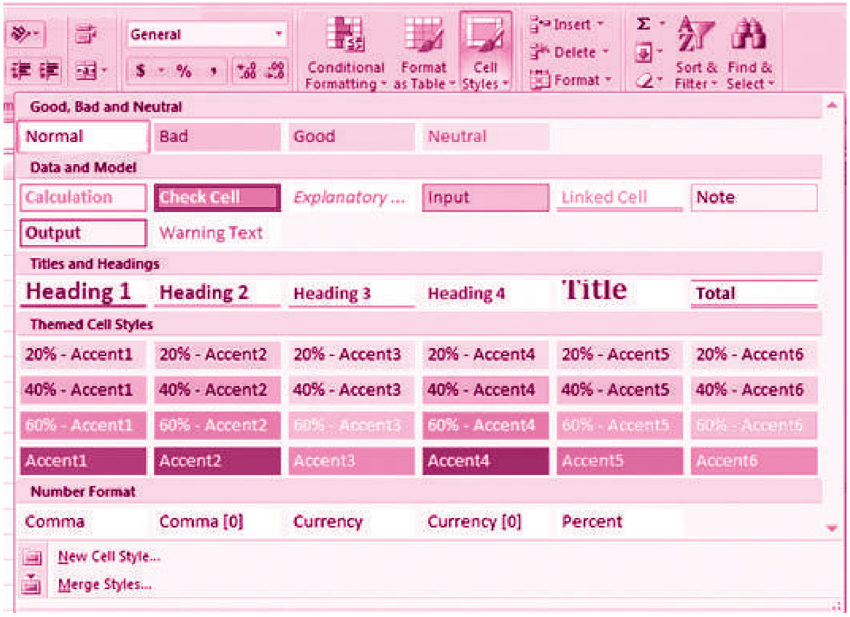
To apply colors manually:





Notes

- Click the **Fill** drop down menu on the **Font** group of the **Home** tab
- Choose the appropriate color

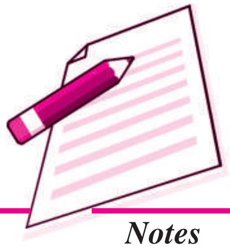


To apply borders and colors using styles:

- Click **Cell** Styles on the **Home** tab
- Choose a style or click **New Cell Style**

35.4.7 Change Column Width and Row Height

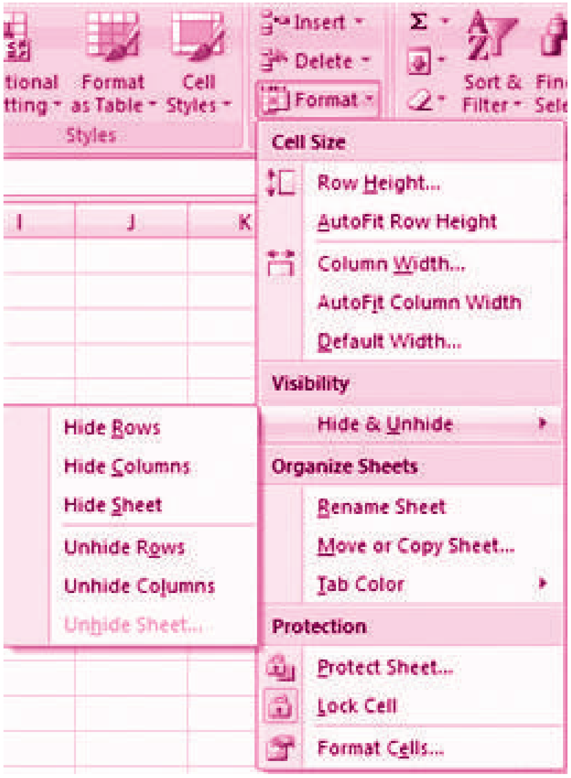
To change the width of a column or the height of a row:



- Click the **Format** button on the **Cells** group of the **Home** tab
- Manually adjust the height and width by clicking **Row Height** or **Column Width**
- To use **AutoFit** click **AutoFit Row Height** or **AutoFit Column Width**

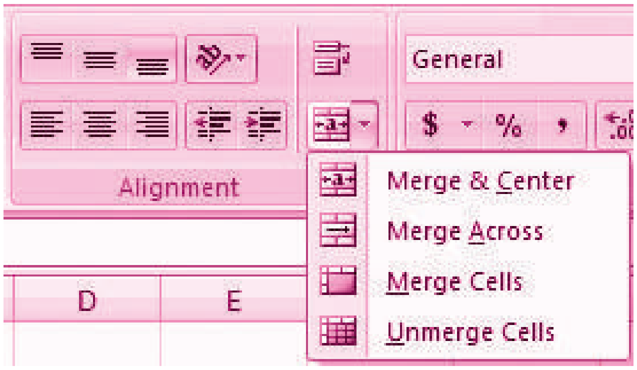
35.4.8 Hide or Unhide Rows or Columns

To hide or unhide rows or columns:



- Select the row or column you wish to hide or unhide
- Click the **Format** button on the **Cells** group of the **Home** tab
- Click **Hide & Unhide**

Merge Cells



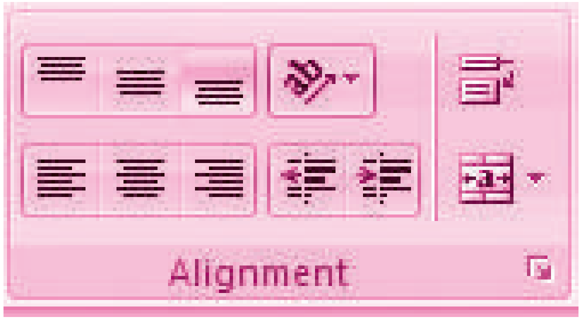
To merge cells select the cells you want to merge and click the **Merge & Center** button on the **Alignment** group of the **Home** tab. The four choices for merging cells are:

Merge & Center	:	Combines the cells and centers the contents in the new, larger cell
Merge Across	:	Combines the cells across columns without centering data
Merge Cells	:	Combines the cells in a range without centering
Unmerge Cells	:	Splits the cell that has been merged

35.4.9 Align Cell Contents

To align cell contents, click the cell or cells you want to align and click on the options within the **Alignment** group on the **Home** tab. There are several options for alignment of cell contents:

Top Align	:	Aligns text to the top of the cell
Middle Align	:	Aligns text between the top and bottom of the cell
Bottom Align	:	Aligns text to the bottom of the cell
Align Text Left	:	Aligns text to the left of the cell
Center	:	Centers the text from left to right in the cell
Align Text Right	:	Aligns text to the right of the cell
Decrease Indent	:	Decreases the indent between the left border and the text
Increase Indent	:	Increase the indent between the left border and the text
Orientation	:	Rotate the text diagonally or vertically



INTEXT QUESTIONS 35.4

Fill in the blanks with suitable word/words:

i. We can split data of one cell into two or more cells by utilizing the convert Text to ___________.

ii. ____________ fonts in Excel will allow you to emphasize titles and headings.

iii. To merge cells, select the cells you want to merge and click the _________ button on Alignment group of the tab.

35.5 CONDITIONAL FORMATTING

Conditional formatting helps the user to highlight interesting cells or range of cells, emphasize unusual values and visualize data by using data bars, colour scales and icon values. The conditional format changes the appearance of a cell range based on given criteria. This implies, if the condition is met/or stands true, the cell range is formatted on that condition; if the condition is false, the cell range is not formatted based on that condition. We will study about this in the subsequent section on 'Output Reports'.

35.6 OUTPUT REPORTS

The entire or partial worksheet(s) can be printed at a time or as and when needed as per the requirement. MS Excel provides an opportunity:

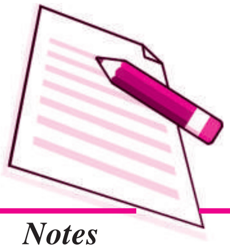
1. Print a partial or entire workbook
2. Print several worksheets at once
3. Print an Excel table
4. Print workbook to file
5. Print graphic charts and Pivot tables.

The procedure to generate a report is given below:

Set Print Titles

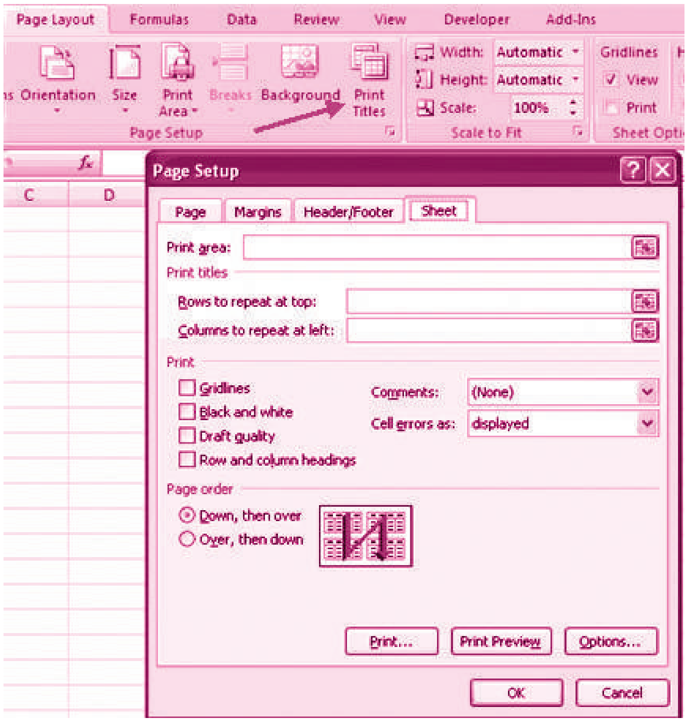
The print titles function allows you to repeat the column and row headings at the beginning of each new page to make reading a multiple page sheet easier to read when printed. To Print Titles:

- Click the **Page Layout** tab on the Ribbon
- Click the **Print Titles** button
- In the **Print Titles** section, click the box to select the rows/columns to be repeated



Notes

- Select the row or column
- Click the **Select Row/Column Button**
- Click OK

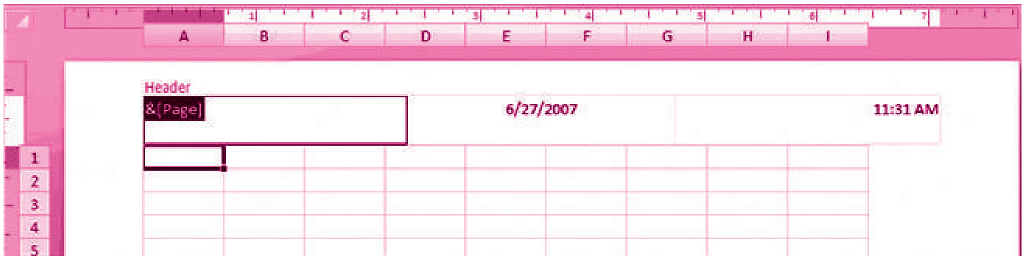


35.6.1 Create a Header or Footer

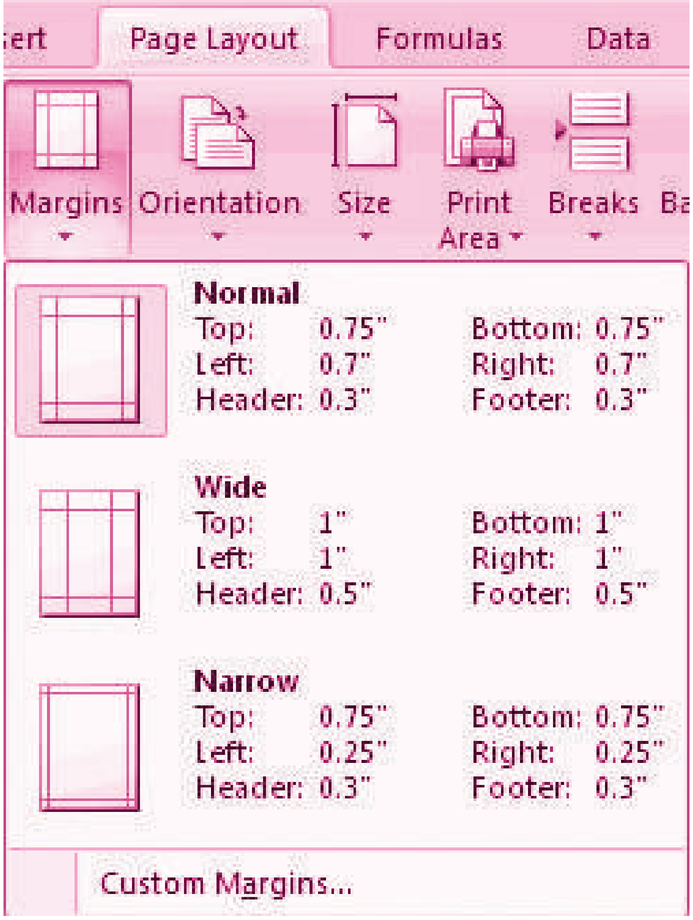
To create a header or footer:

- Click the **Header & Footer** button on the **Insert** tab
- This will display the **Header & Footer Design Tools Tab**
- To switch between the Header and Footer, click the **Go to Header** or **Go to Footer** button

- To insert text, enter the text in the header or footer
- To enter preprogrammed data such as page numbers, date, time, file name or sheet name, click the appropriate button
- To change the location of data, click the desired cell

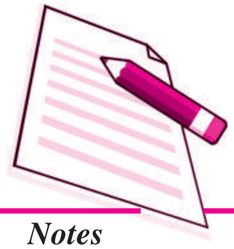


35.6.2 Set Page Margins

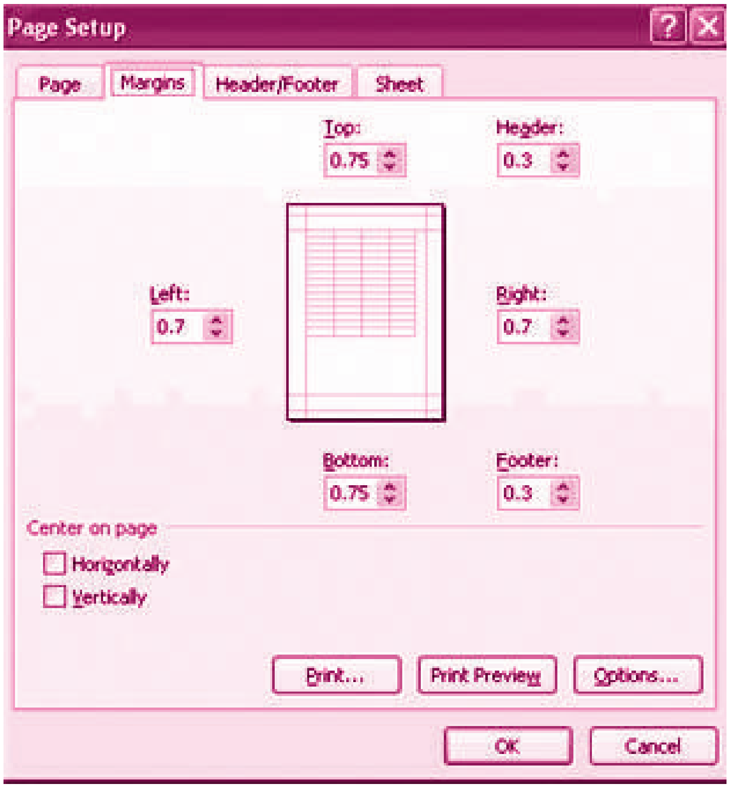


To set the page margins:

- Click the **Margins** button on the **Page Layout** tab
- Select one of the given choices, or
- Click **Custom Margins**
- Complete the boxes to set margins
- Click **Ok**

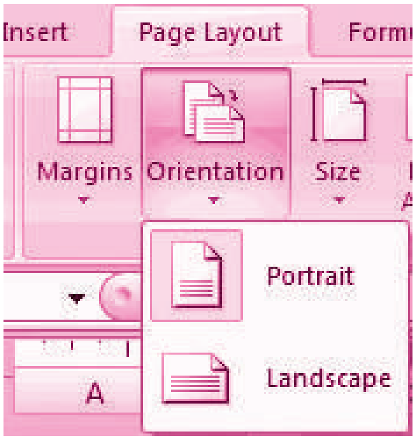


Notes



Change Page Orientation

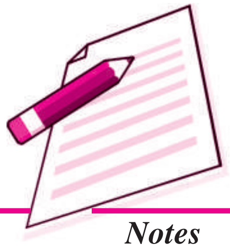
To change the page orientation from portrait to landscape:

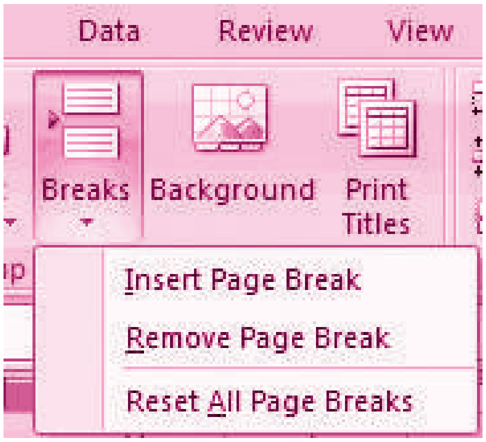


- Click the **Orientation** button on the **Page Layout** tab
- Choose **Portrait** or **Landscape**

35.6.3 Set Page Breaks

You can manually set up page breaks in a worksheet for ease of reading when the sheet is printed. To set a page break:



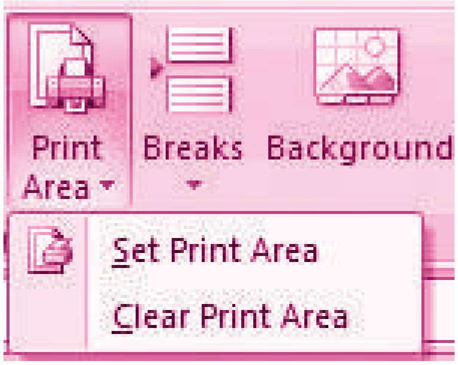


- Click the **Breaks** button on the **Page Layout** tab
- Click **Insert Page Break**

Print a Range

There may be times when you only want to print a portion of a worksheet. This is easily done through the Print Range function.

To print a range:

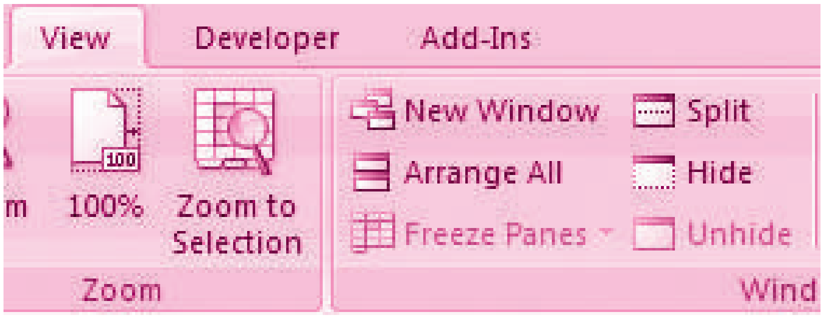


- Select the area to be printed
- Click the **Print Area** button on the **Page Layout** tab
- Click **Select Print Area**

Split a Worksheet

You can split a worksheet into multiple resizable panes for easier viewing of parts of a worksheet. To split a worksheet:

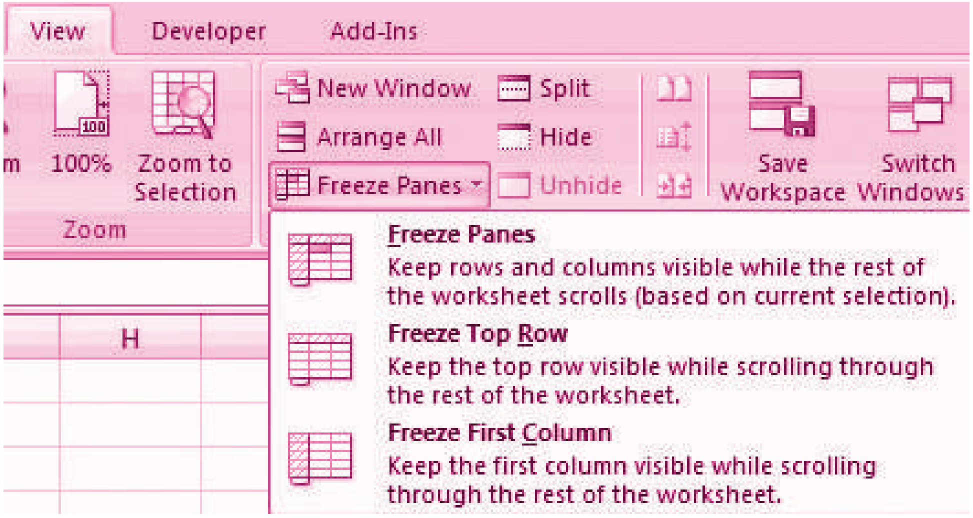
- Select any cell in center of the worksheet you want to split
- Click the **Split** button on the **View** tab
- Notice the split in the screen, you can manipulate each part separately



35.6.4 Freeze Rows and Columns

You can select a particular portion of a worksheet to stay static while you work on other parts of the sheet. This is accomplished through the Freeze Rows and Columns Function. To Freeze a row or column:

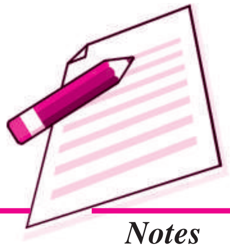
- Click the **Freeze Panes** button on the **View** tab
- Either select a section to be frozen or click the defaults of top row or left column
- To unfreeze, click the **Freeze Panes** button
- Click **Unfreeze**

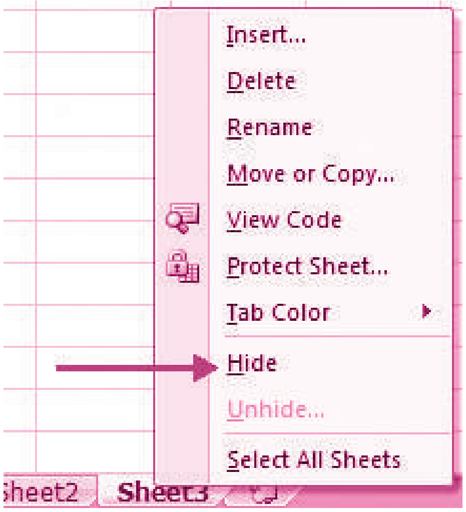


35.6.5 Hide Worksheets

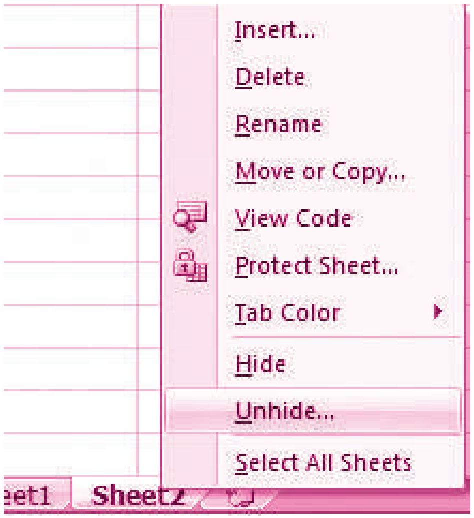
To hide a worksheet:

- Select the tab of the sheet you wish to hide
- **Right-click** on the tab
- Click **Hide**





To unhide a worksheet:



- **Right-click** on any worksheet tab
- Click **Unhide**
- Choose the worksheet to unhide

35.7 PREPARATION OF REPORTS USING PIVOT TABLE

A Pivot table is a way to present information in a report format. **A** Pivot Table report provides enhanced layout, attractive and formatted report with increased readability. It is an interactive way of summarizing large amounts of data. These features lead to the following advantages for the benefit of users:

- Querying large amounts of data in user friendly ways.
- Expanding and collapsing levels of data to focus on results.

Notes

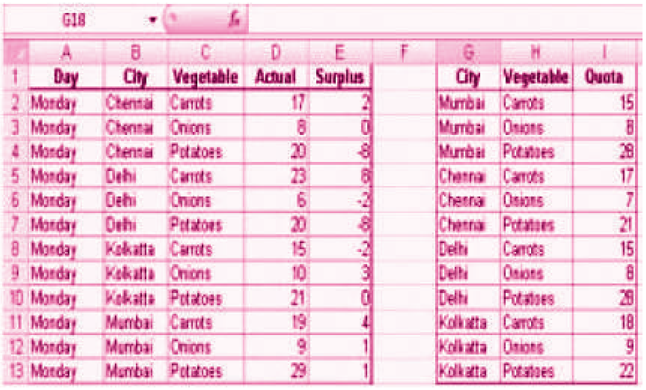
- Moving rows to column (s) to look for different summaries of the source data.
- Filtering, sorting, grouping and conditionally formatting the required information of interest of user.
- Pivot table report helps in analyzing related totals, when there are long list of figures to sum and to compare several facts about each figure.

Pivot Table Toolbar

The Pivot Table uses a List Data table. A data table is a range of cells that shows the results of substituting different values in one or more formulas. There are two types of data tables: One variable and two variable table. Formula used in a one-variable data table must refer to an input cell. The input cell is a cell used by Excel in which each input value from a data is substituted. Two variable data table uses only one formula with two lists of input values. The data must refer to two different input cells.

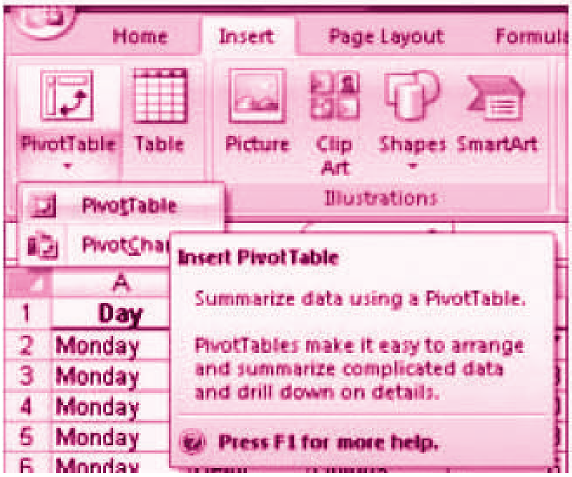
Designing a Pivot table Report of 3 vegetable consumption of four Metro cities

1. Enter the vegetable consumption data in the worksheet

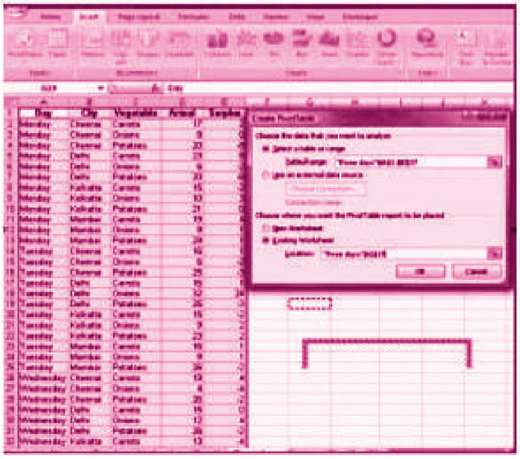


	Day	City	Vegetable	Actual	Surplus		City	Vegetable	Quota
2	Monday	Chennai	Carrots	17	2		Mumbai	Carrots	15
3	Monday	Chennai	Onions	8	0		Mumbai	Onions	8
4	Monday	Chennai	Potatoes	20	-8		Mumbai	Potatoes	28
5	Monday	Delhi	Carrots	23	6		Chennai	Carrots	17
6	Monday	Delhi	Onions	6	-2		Chennai	Onions	7
7	Monday	Delhi	Potatoes	20	-8		Chennai	Potatoes	21
8	Monday	Kolkatta	Carrots	15	-2		Delhi	Carrots	15
9	Monday	Kolkatta	Onions	10	3		Delhi	Onions	8
10	Monday	Kolkatta	Potatoes	21	0		Delhi	Potatoes	28
11	Monday	Mumbai	Carrots	19	4		Kolkatta	Carrots	18
12	Monday	Mumbai	Onions	9	1		Kolkatta	Onions	9
13	Monday	Mumbai	Potatoes	29	1		Kolkatta	Potatoes	22

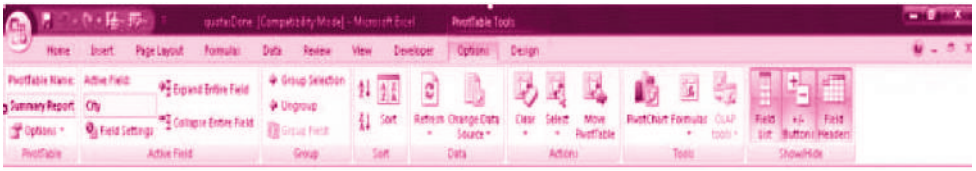
2. On the Insert tab in the Tables group, click Pivot table. Report interactive options as Create Pivot Report

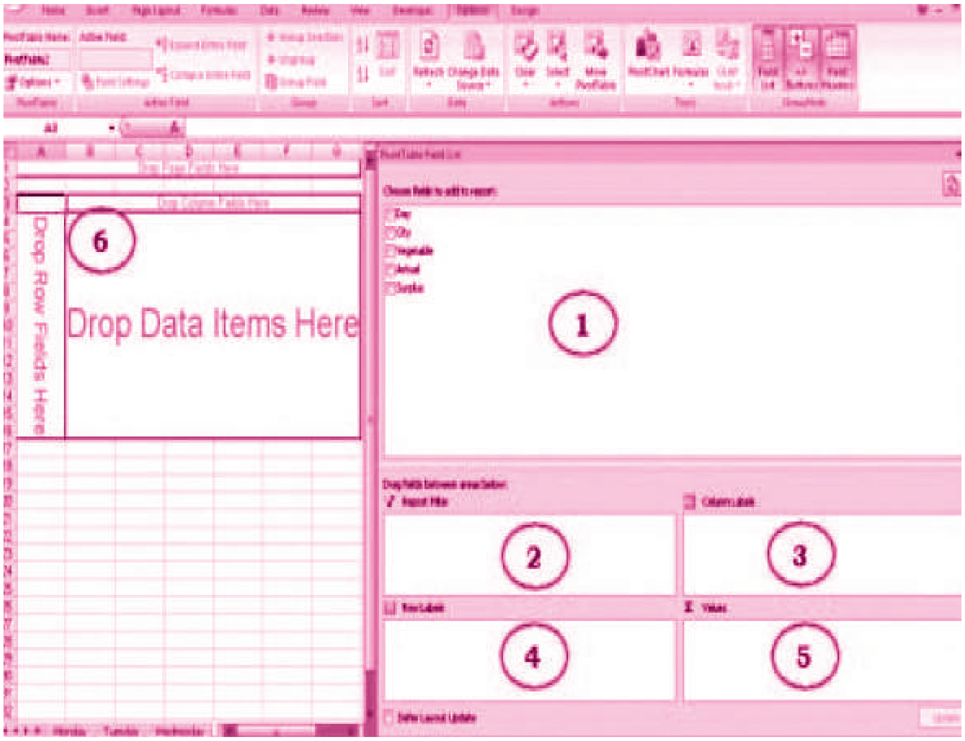


3. Enter the data location and choose to place Pivot table on the existing worksheet.



4. Click OK to display a blank Pivot table and filed list and Excel displays a Pivot table tool bar.





5. Drag the Field Names to the required positions in the Pivot Table

	A	B	C	D	E
1	Day	(All)			
2					
3	Sum of Actual	Vegetable			
4	City	Carrots	Onions	Potatoes	Grand Total
5	Chennai	52	18	71	141
6	Delhi	54	50	71	175
7	Kolkatta	43	25	66	134
8	Mumbai	50	30	81	161
9	Grand Total	199	123	289	611

6. Pivot Table will be generated

	A	B	C
1	Day	(All)	
2			
3	Sum of Actual		
4	City	Vegetable	Total
5	⊟Chennai	Carrots	52
6		Onions	18
7		Potatoes	71
8	Chennai Total		141
9	⊟Delhi	Carrots	54
10		Onions	50
11		Potatoes	71
12	Delhi Total		175
13	⊟Kolkatta	Carrots	43
14		Onions	25
15		Potatoes	66
16	Kolkatta Total		134
17	⊟Mumbai	Carrots	50
18		Onions	30
19		Potatoes	81
20	Mumbai Total		161
21	Grand Total		611

Common Errors in spread sheet.

INTEXT QUESTIONS 35.5

Fill in the blanks with suitable word/words:

i. The ___________ format changes the appearance of a cell range based on given criteria.

ii. A __________ table is a way to present information in a report format.

iii. A ___________ table is a range of cells that shows the results of substituting different values in one or more formulas.

iv. Two variable data table uses only one formula with two lists of __________ values.

WHAT YOU HAVE LEARNT

- **Electronic Spreadsheet :** Electronic Spreadsheet is a combination of rows and columns. It is also known as a worksheet. This worksheet is so large that the human eye can not view all its rows and columns at a point of time.
- **Basics and Features of Spreadsheet :** (1) Grid; (2) Element; (3) Lens View; (4) Functions; (5) Formatting; (6) Save Print and Export
- **Data Entry, Text Management and Cell Formatting :** Excel is one of the software that is bundled with MS office to implement the spreadsheet described above. Here under, we will be exhibiting the visuals using MS Excel 2007.
- **Basic features offered by MS Excel are:**

  Workbook and Worksheet in Excel : Spreadsheet referred to as a worksheet in Excel. This worksheet is a single page of a workbook, which is a multipage document.

  Worksheet Operations : The following worksheet operations are associated with the spread sheet : (i) Movement of Cell Pointer; (ii) Short-Cut Menu; (iii) Entering Data into Cells; (iv) Selecting Multiple Cells; (v) Managing Text in Excel
- **Performing Calculations in Excel :** A formula is a set of mathematical instructions that can use in Excel to perform calculations. Formulas are started in the formula box with an = sign.

There are many elements to and excel formula.

References ***Operators*** ***Constants*** ***Functions***

- **Calculate with Functions :** A function is a built in formula in Excel. A function has a name and arguments (the mathematical function) in parentheses. Common functions in Excel:

Sum ***Average*** ***Min*** ***Max*** ***Count***

- **Function Library :** The function library is a large group of functions on the Formula Tab of the Ribbon. These functions include:

AutoSum ***Recently Used*** ***Financial*** ***Logical***

Text ***Date & Time*** ***Math & Trig***

- **Relative, Absolute and Mixed References :** Calling cells by just their column and row labels (such as “A1”) is called **relative referencing**.
- **Mixed referencing** can also be used where only the row or column is fixed.

- **Data Formatting :** Formatting of spreadsheet makes easier to read and understand the important information. This is chiefly categorized as follows:

  Number formatting : Number formatting includes adding per cent (%), Comma (,), decimal (.), currency (Rs., $), date, time, scientific values etc. Refer figure 1 given below which depicts the unformatted worksheet:

  From the Ribbon select, Home Tab with Number option. Click on **Format Cells** dialog box and choose **Number** tab.

  The **Category** list shows all the preset formulas available in Excel, grouped into categories.

  If we select **Currency**, the right hand side shows the different symbols of currencies.

  Change the number of decimal spaces to zero (0).

  Click OK to accept this format. The final output is shown below:

- **Text and General Formatting :** We can do this easily by utilizing the Convert Text to Columns Wizard.

- **Modify Fonts :** Modifying fonts in Excel will allow you to emphasize titles and headings.

- **Format Cells Dialog Box :** In Excel, you can also apply specific formatting to a cell.

  Number : Allows for the display of different number types and decimal places

  Alignment : Allows for the horizontal and vertical alignment of text, wrap text, shrink text, merge cells and the direction of the text.

  Font : Allows for control of font, font style, size, color, and additional features

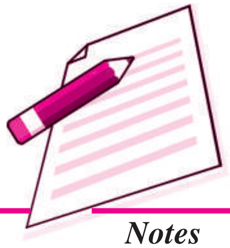
  Border : Border styles and colors

  Fill : Cell fill colors and styles

- **Add Borders and Colors to Cells :** Borders and colors can be added to cells manually or through the use of styles.

- **Merge Cells :** To merge cells select the cells you want to merge and click the **Merge & Center** button on the **Alignment** group of the **Home** tab. The four choices for merging cells are:

  Merge & Center   Merge Across   Merge Cells
  Unmerge Cells   Align Cell Contents



Notes

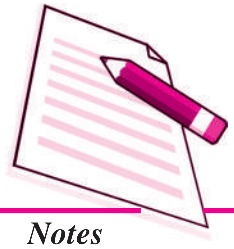
- To align cell contents, click the cell or cells you want to align and click on the options within the **Alignment** group on the **Home** tab. There are several options for alignment of cell contents:

Top Align	Middle Align	Bottom Align
Align Text Left	Center	Align Text Right
Decrease Indent	Increase Indent	Orientation

- **Conditional Formatting :** Conditional formatting helps the user to highlight interesting cells or range of cells, emphasize unusual values and visualize data by using data bars, colour scales and icon values.
- **Output Reports :** The entire or partial worksheet(s) can be printed at a time or as and when needed as per the requirement.
- **Set Print Titles :** The print titles function allows you to repeat the column and row headings at the beginning of each new page to make reading a multiple page sheet easier to read when printed.
- **Set Page Breaks :** You can manually set up page breaks in a worksheet for ease of reading when the sheet is printed.
- **Print a Range :** There may be times when you only want to print a portion of a worksheet. This is easily done through the Print Range function.
- **Split a Worksheet :** You can split a worksheet into multiple resizable panes for easier viewing of parts of a worksheet.
- **Freeze Rows and Columns :** You can select a particular portion of a worksheet to stay static while you work on other parts of the sheet.
- **Preparation of Reports Using Pivot Table :** A Pivot table is a way to present information in a report format.
- **Pivot Table Toolbar :** The Pivot Table uses a List Data table. A data table is a range of cells that shows the results of substituting different values in one or more formulas.

TERMINAL EXERCISE

1. What is Electronic Spread Sheet?
2. What is the basic requirement for any business enterprise for using electronic spread sheet?
3. Name the functions included in 'Function Library'.



Notes

4. What is conditional formatting?
5. Give the meanings of workbook & worksheet.
6. Explain the features of Spreadsheet.
7. Explain the worksheet operations in excel sheet.
8. Define workbook & worksheet. What is the difference between them?
9. What do you mean by active worksheet?
10. Explain the procedure of managing Text in excel.
11. Explain worksheet operations available in Excel Sheet.
12. Give Categories of Data formatting and explain them.
13. What benefits are available with the help of conditional formatting.
14. Explain the procedure of preparation of Reports using Pivot Table.

ANSWERS TO INTEXT QUESTIONS

35.1. i. grid ii. intersection iii. rows, columns iv. functions v. alterations

35.2. i. intersect ii. arrow iii. handy, commonly iv. cell, cell v. drag

35.3. i. sum ii. count iii. average iv. max v. min

35.4. i. columns wizard ii. modifying iii. merge & center

35.5. i. conditional ii. pivot iii. data iv. input

36

USE OF SPREADSHEET IN BUSINESS APPLICATIONS

We have learnt about the spreadsheet and its features that can use in business applications. The spreadsheet lends support to a number of areas of accounting. This section describes its applications in two areas: Pay roll and Depreciation accounting to illustrate the capability of spreadsheet to enable computer based accounting.

In this lesson, we shall discuss the applications of spreadsheet (using Excel) to Payroll Accounting and Asset Management Accounting.

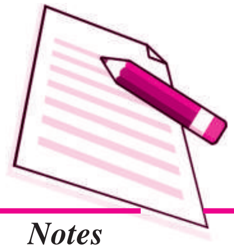
OBJECTIVES

After studying this lesson you will be able to :

- state the meaning of Payroll Accounting;
- explain the components of Payroll;
- state the meaning of Depreciation;
- explain the methods of Depreciation;
- compute the amount of annual depreciation with the help of computer and
- maintain the accounts of assets on computers.

36.1 PAYROLL

Every employee in an organization is paid remuneration to compensate for (or in consideration of) services rendered during a particular period. This compensation is called Salary or more popularly, Pay to the people in employment. Salary is payable with reference to a pre determined period of time (usually a month). That is why the salary is normally specified on a monthly basis. In order to avoid subjectivity in determining the salary payable to various employees, almost every modern organization follows a definite set of rules to decide the salary payable to their employees. Use of Computers for maintaining the records Salary of employees is known as Payroll accounting.



36.1.1 Payroll Components

Every employee, when appointed by the organization enters into a contract of service in which these pay rules are incorporated as terms and conditions of employment.

Current Payroll Period (Month And Year)

Earnings

- **Basic Pay (BP) :** It is the pay in the pay scale plus Grade Pay, but does not include Special Pay.
- **Grade Pay (GP) :** It is the pay to be added to the Basic Pay according to the designation of the employee and applicable pay band or scale of pay.
- **Dearness Pay (DP) :** It is that portion of Dearness Allowance, which has been declared and deemed to have been merged with the Basic Pay.
- **Dearness Allowance (DA) :** It is a compensation for erosion in the purchasing power of wage earner due to price rise. It is granted by the employer periodically as a percentage of (Basic Pay + Dearness Pay, if applicable).
- **House Rent Allowance (HRA) :** It is an amount paid to facilitate employee in acquiring on lease of residential accommodation.
- **Transport Allowance (TRA) :** It is an amount to facilitate commuting to the place of work.
- **Any Other Earning :** It may include any other allowance not included above but declared from time to time, such as Children Education Allowance, Medical Allowance, Washing Allowance, etc.

Deductions

- **Professional Tax (Applicable in some states) (PT) :** It is a statutory deduction according to the legislature of the State Government.
- **Provident Fund (PF) :** It is a statutory deduction, as part of social security. It is decided by the Government under the Provident Fund Act and is computed as a percentage of (Basic Pay + Dearness Pay, if applicable).
- **Tax Deduction at Source (TDS) :** It is a statutory deduction, which is deducted monthly towards Income Tax liability of an employee. It is essentially an apportionment of yearly Income Tax liability over 12 months.
- **Recovery of Loan Instalment (LOAN) :** Any amount signified by the employee for deduction on account of any loan taken up by him/her.

- **Any Other Deduction :** It may include any other deduction not included above such as Recovery of Advance against Salary, deductions on account of Food Grain Advance., .Festival Advance., etc.

  i. ***Gross :*** The Gross amount of salary is the salary due to each employee, which normally consists of Basic Pay and various Allowances. The most common allowances are Dearness Allowance, House Rent Allowance, City Compensation Allowance, Transport Allowance etc. The gross salary payable to each employee is computed as an aggregate of basic pay and the applicable allowances as per the terms and conditions of employment.

  ii. ***Deductions :*** Every employee is required to contribute from the monthly salary a certain percentage of basic salary towards provident fund. Accordingly, the amount of contribution is deducted from the salary due. Further, the organization as employer is required to deduct subject to provisions of Income Tax Act, a certain amount as Tax Deduction at Source (TDS) from salary of each employee. In addition to this, there may be many other voluntary and compulsory deductions from the salary due to employees.

  iii. ***Net Salary :*** The net amount of salary is the difference between gross salary and deductions. Net amount of salary is to be paid to each employee at the end of a month.

Payroll is an accounting statement that is meant to show the salary payable to each employee by providing details of the gross salary, various amounts of deductions and finally net amount payable to such employee.

INTEXT QUESTIONS 36.1

Fill in the blanks :

i. Salary is normally specified on a ______________ basis.

ii. Contract of employment & Pay rules are known as ________________.

iii. ______________ Allowance paid to facilitate employee in acquiring residential accommodation on lease/rent.

36.2 ELEMENTS USED IN PAYROLL CALCULATION

Basic Pay Earned (BPE) . Basic Pay Earned of an employee is the Basic Pay calculated with reference to Number of Effective Days present (NOEDP) during the month.

BPE = BP * NOEDP/NODM

Dearness Allowance (DA)

DA = *BPE * (Applicable Rate of DA for the Month)*

House Rent Allowance (HRA)

HRA = *BPE * (Applicable Rate of HRA for the Month)*

Transport Allowance (TRA)

TRA = *(Fixed Amount) or (On Percentage Basis)*

Total Earnings (TE). It is the aggregate of all the above earning elements. Thus,

TE = BPE + DA + HRA + TRA

Provident Fund (PF) : This can be calculated as ***PF = BPE * PF Rate Press Enter***

Tax Deduction at Source (TDS) : It is usually a fixed amount deducted every month on account of TDS. In the last quarter of a year, the investment details, which are permissible for tax deduction, are received from employees to compute the quarterly and yearly income tax liability more accurately.

Recovery of Loan Instalments (LOAN) : It is a fixed amount to be deducted on account of Loan Installment as part of loan recovery.

Total Deductions (TD) : It is the total of all the above deductions. Thus,

TD = PF + TDS + LOAN

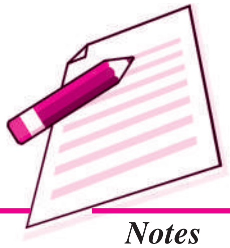
Number of Effective Days Present (NOEDP) *is the Number of Days in a Month Minus Leave without Pay minus Unauthorised Absence, i.e.* ***NOEDP = (Number of Days in a Month)***-*(Leave without Pay)-(Unauthorised Absence) ; where 'Number of Days in a Month' may be denoted by NODM.* The Net Salary (NS) is the amount payable to an employee. It is obtained by deducting Total Deductions (TD) from Total Earnings (TE) as given below :

Net Salary (NS) = Total Earnings (TE) - Total Deductions (TD)

The basic elements used in payroll calculations are shown in following table:

Basic Pay Earned (BPE)	$BP \times \frac{NOEDP}{NODM}$ Where, NOEDP is Number of Effective Days Present (Total number of days in a month - Leave without pay and Unauthorized absence) NODM is Number of Days in a Month

DA and HRA	BPE x Rate of DA BPE x Rate of HRA
Transport Allowance (TRA)	Fixed Amount or on Percentage Basis
Total Earnings (TE)	BPE + HRA + TRA
Provident Fund	BPE x PF rate
Other Deductions : Tax Deduction at Source Recovery of Loan Installments	These are calculated and deducted for employee.
Total Deductions (TD)	PF + TDS + Loan Repayment
Net Salary (NS)	Total Earning (TE) - Total Deduction (TD)

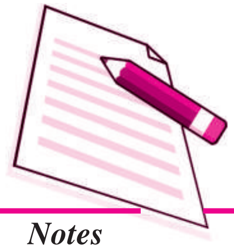


Notes

36.3 PAYROLL DESIGN USING MS EXCEL

Column	Column Heading	Abbrev Ref	First line shows Required Formula Second line refers the cell content
A	Employee No	Emp No	Value entered directly
B	Employee Name	Emp Name	Value entered directly
C	Employee Type	Emp Type	Value entered directly
D	Deduction Days	Ded Days	Value entered directly
E	Basic Pay	BP	Value entered directly
F	No. of Effective Days Present	NOEP	= NODM – (Ded Days) = $I$3-D12
G	Basic Pay Earned	BPE	= BP * NOEP/NODM = E12*F12/$I$3
H	Dearness Allowance	DA	= BPE * DA Rate (in %) = G12*$I$4
I	House Rent Allowance	HRA	= If (Emp Typ = "Sup" then 40% of BPE else if (Emp Typ = "Nsup" then 30% of BPE else 0)) = IF(C12="Sup". G12*$I$5. IF(C12 ="Nsup". G12*I6.0))
J	Transport Allowance	TRA	= If (Emp Typ = "Sup" then 1000 else if (Emp Typ = "Nsup" then 500 else 0)) = IF(C12="Sup".$I$7.IF(C12 ="Nsup".I8.0))
K	Gross Salary	TE	= BPE + DA + HRA + TRA = G12+H12+I12+J12
N	Provident Fund	PF	= BPE * PF Rate (in %) = G12*$I$9
O	Tax Deduction at Source	TDS	Value entered directly
P	Loan Repayment Inst.	LOAN	Value entered directly
Q	Total Deductions	TD	= PF + TDS + LOAN= N12+O12+P12
R	Net Salary	NS	= TE – TD= K12-Q12

Figure 36.1 : Spreadsheet Columns and the Cells Content in Spreadsheet



Notes

Variable/Type of Employee	*Value in % or Fix Value*	*Remark*
Dearness Allowance (DA)	35% of Basic Pay	I4
House Rent Allowance (HRA) –:		
Supervisory Employee (Sup)	40% of Basic Pay	I5
Non-supervisory Employee (Nsup)	30% of Basic Pay	I6
Consultant or Contract Employee	Nil	
Provident Fund (PF)	12% of BP +DA	I9

Figure 36.2 : Rules for Computing Some of Payroll Elements

Generating the Monthly Statement

	A	B	C	D	E	F	G	H	I	J	K
1	M/S X Y Z Enterprises										
2	Payroll for the Month of February, 2009										
3			No. of Days in a Month (NOMD) For February, 2009:						28		
4			DA Rate Applicable for February, 2009:						35%		
5			HRA Rate for Supervisory Staff:						40%		
6			HRA Rate for Non-supervisory Staff:						30%		
7			Transport Allowance for Supervisory Staff						1000		
8			Transport Allowance for Non-supervisory Staff						500		
9			PF Rate:						12%		
10	Emp. No.	Emp Name	Emp Type	Ded Days	Basic Pay	No. of Eff. Days	Basic Pay Earned	DA	HRA	TRA	Total Earnings
11	101	Sanjay	Sup	1.5	16500	26.5	15616.07	5465.63	6246.43	1000	28328.13
12	341	Nimita	Sup	0.0	34000	28.0	34000.00	11900.00	13600.00	1000	60500.00
13	461	Rohanlal	Sup	0.0	19000	28.0	19000.00	6650.00	7600.00	1000	34250.00
14	561	Aishwarya	Sup	3.0	23000	25.0	20535.71	7187.50	8214.29	1000	36937.50
15	701	Rohitkumar	Sup	1.0	15000	27.0	14464.29	5062.50	5785.71	1000	26312.50
16	941	Kapildev	Sup	0.0	40000	28.0	40000.00	14000.00	16000.00	1000	71000.00
17	1061	Anshuman	Sup	4.0	36000	24.0	30857.14	10800.00	12342.86	1000	55000.00
18	1181	Sachin	Nsup	0.0	9500	28.0	9500.00	3325.00	2850.00	500	16175.00
19	1421	Priyanka	Sup	0.0	23000	28.0	23000.00	8050.00	9200.00	1000	41250.00
20	1541	Nargis	Nsup	0.0	8000	28.0	8000.00	2800.00	2400.00	500	13700.00
21	1661	Ashok	Nsup	0.0	8500	28.0	8500.00	2975.00	2550.00	500	14525.00
22	1781	Rajesh	Nsup	0.5	9000	27.5	8839.29	3093.75	2651.79	500	15084.82
23	2021	Motilal	Cont	0.5	20000	27.5	19642.86	6875.00	0.00	0	26517.86
24	2141	Balraj	Cnst	2.0	25000	26.0	23214.29	8125.00	0.00	0	31339.29
25		Total					275169.64	96309.38	89441.07	10000	470920.09

Figure 36.3 (a) : Partial Spreadsheet Showing Payroll List upto Gross Salary

	A	B	N	O	P	Q	R
2							
3							
10	Emp. No.	Emp Name	PF	TDS	Loan Instalment	Total Deduction	Net Salary
11	101	Sanjay	1873.93	3300	0	5173.93	23154.20
12	341	Nimita	4080.00	6800	2400	13280.00	47220.00
13	461	Rohanl‹	2280.00	3800	1200	7280.00	26970.00
14	561	Aishwa‹	2464.29	4600	0	7064.29	29873.21
15	701	Rohitku	1735.71	3000	0	4735.71	21576.79
16	941	Kapilde	4800.00	8000	3000	15800.00	55200.00
17	1061	Anshun	3702.86	7200	2600	13502.86	41497.14
18	1181	Sachin	1140.00	1900	0	3040.00	13135.00
19	1421	Priyank	2760.00	4600	0	7360.00	33890.00
20	1541	Nargis	960.00	1600	0	2560.00	11140.00
21	1661	Ashok	1020.00	1700	1100	3820.00	10705.00
22	1781	Rajesh	1060.71	1800	0	2860.71	12224.11
23	2021	Motilal	2357.14	4000	0	6357.14	20160.71
24	2141	Balraj	2785.71	5000	0	7785.71	23553.57
25		Total	33020.36	57300	10300	100620.36	370299.73

Figure 36.3 (b) : Partial Spreadsheet for calculation of Deductions & Net Salary

INTEXT QUESTIONS 36.2

Write the full form of the following :

i.	BPE	ii.	DA	iii.	TRA
iv.	HRA	v.	PF	vi.	TDS

36.4 DEPRECIATION

Depreciation is calculated according to the policy of the organisation. There are basically two methods, namely the Straight Line Method (SLM) and the Written Down Value Method (WDV). We will recall that asset accounting requires maintenance of asset.

Computation of depreciation and preparation of schedule of fixed assets for reporting in the balance sheet as part of the annual accounts. In order to prepare this report the depreciation calculation sheet is also to be prepared.

Depreciation is an allocation of the depreciable cost of a non-current (fixed) asset over its useful life. It is a way of matching the amount of a fixed cost consumed in an accounting period with the revenue it generates. Depreciation is a process of cost allocation. This is based on factors such as useful life, scrap value and cost of asset put to use. Depreciation expense is the amount of cost allocation within an accounting period. Only items that lose useful value over time can be depreciated except freehold land whose value generally does not decrease.

Depreciation is calculated according to the policy of the organization. The Companies Act 1956 in Schedule XIV lists the rate of depreciation to be used for different types of assets under Straight line and Written down Value method.

Excel worksheet supports the functions of SLN (Straight line), DB (Diminishing Balance, DDB (Double Declining Balance), SYD (Sum of Years Digit) to compute depreciation on Assets.

In this section, are concentrating only on Straight line and Written down Value method of depreciation.

INTEXT QUESTIONS 36.3

Fill in the blanks :

i. ______________ is an allocation of the depreciable cost of a non-current asset over its useful life.

ii. Depreciation is a process of cost ____________.

iii. Excel worksheet supports the functions of Straight Line Method, Diminishing Balance Method and ______________ Method.

36.5 COMPUTERISED ASSET ACCOUNTING

Assets are classified into the following categories:

- Goodwill
- Land: Free-hold land and Lease-hold land
- Building: Factory building, Office building, and Residential building. Plant and Machinery
- Furniture and Fixtures
- Vehicles
- Capital work in progress
- Others

The Companies Act, 1956 in Schedule-14 lists the rate of depreciation to be used for different class of assets under Straight Line Method (SLM) and Written Down Value Method (WDV). The prescribed rates are different under two methods. For reporting purposes, corporate enterprises may use either of the method and applicable rates. Let us now understand the computation of depreciation using the two methods.

36.5.1 Straight Line Method of Depreciation

According to this method, the acquisition cost of asset and the net value is allocated over its useful life span by charging a constant amount of depreciation. This is computed as follows:

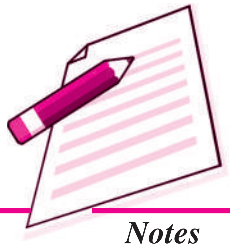
i. Acquisition cost = Purchase value + other expenses such as transportation expenses, installation expenses and pre operating expenses.

ii. Total Depreciable amount = Acquisition cost – Salvage value

Hence, Straight line depreciation is calculated as : $\dfrac{\text{Total Depreciable Amount}}{\text{Expected Useful Life}}$

$$\text{Rate of Depreciation} = \frac{\text{Straightline Depreciation}}{\text{Total Depreciable Amount}} \times 100$$

Hereunder, we will now compute the depreciation by straight line method using the inbuilt function SLN. The depreciation is being computed on two assets: CNC machine and Packing machine. For this, enter the values in the worksheet as shown in the table:



Column	Column Heading	Abbrev Ref	First line shows Required Formula Second line refers the cell content
A	Asset Name	Asset Name	Value entered directly
B	Date of Purchase	Pur. Date	Value entered directly
C	Date of Installation	Inst. Date	Value entered directly
D	Cost of Purchase	Pur. Cost	Value entered directly
E	Installation Expenses	Inst. Exp.	Value entered directly
F	Pre-operating Expenses	Pre-op Exp	Value entered directly
G	Cost to Use	Cost to Use	= (Cost of Purchase) + (Installation Expenses) + (Pre-operating Expenses) = D5+E5+F5
H	Salvage Value	Salvage Val	Value entered directly
I	Life of Asset in Years	Life in Yrs	Value entered directly
K	Depreciation Amount	Depr.	=SLN(G5,H11,I11)

2	Calculation of Depreciation for the Financial Year 2008-09 (SLM Method)						
3		Year-Beg-Dt	01-Apr-08		Year-End Dt	31-Mar-09	
4	Asset Name	Purchase Date	Installation Date	Purchase Cost	Installation Expenses	Pre-Operation Expenses	Cost to Use
5	CNC Machine	11-Jul-08	17-Jul-08	877000	11000	3000	891000
6	Packing Machine	03-May-06	07-May-06	123000	8000	2500	133500

8	Calculation of Depreciation for the Financial Year 2008-09 (SLM Method)				
9		Total No of Days	365		
10	Asset Name	Salvage Value	Life in Years	Allowed Depreciation	Depreciation
11	CNC Machine	45000	7	100%	120857.14
12	Packing Machine	17000	7	100%	16642.86

Excerpts of the Spread sheet showing the depreciable amount

36.5.2 Written down Value method of Depreciation

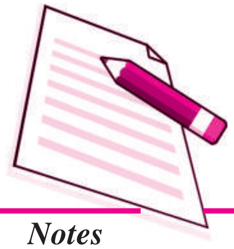
According to this method, the amount of depreciation is calculated at a fixed rate on the cost of assets as reduced by the amount of depreciation charged upto date. Function DB computes and returns the depreciation of an asset for a specified period using written down value method. The parameters for its computation are:

Cost : refers to the initial cost of the asset.

Life : also called useful life of the asset is the number of periods over which the asset is being depreciated.

Salvage : also called salvage value of the asset, is a value at the end of life of asset.

Period : is the period for which the depreciation is calculated. The unit of period is the same as that of life.



Notes

Month : is the number of months in the initial year. If the month is omitted, it is assumed to be 12.

Hereunder, we will now compute the depreciation by Diminishing Balance method using the inbuilt function DB. The depreciation is being computed on two assets: CNC machine and Packing machine. For this, enter the values in the worksheet as shown in the table: The following table presents the column items and contents used in the spreadsheet.

Column	*Column Heading*	*Abbre. Ref*	*First line shows Required Formula* *Second line refers the cell content*
I	Life of Asset in Years	Life in Yrs	Value entered directly
J	Period (in Years) for which Depr. is to be computed	Period	If (Instalation of asset was done after March) then take (Current Year) – (Year of Instalation) else take one addl. Year. = IF (MONTH(C5) > 3.(YEAR($F$3)-YEAR(C5)).(YEAR($F$3)-YEAR(C5))+1)
K	Months in 1st Year (i.e. the year of installation)	Months in 1st Yr	No. of months between (Yr-End-Dt in 1st Yr) & (Inst.Date) = ROUND((L5-C5)/30.0)
L	Year-end Date in 1st Year (Reqd. to compute column-K)	Yr-End-Dt in 1st Yr	If (Inst. Date) was Between Jan and Mar. Take it as 31st Mar of (Year of Inst. Date) Else Take it as Next Year. = IF(AND(MONTH(C5)>0.MONTH(C5) <4). DATE(YEAR(C5).3.31). DATE(YEAR(C5)+1.3.31))
M	Depreciation	Depr.	Parameters of DB function as explained above = DB(G5.H5.I5.J5.K5)

2	**Calculation of Depreciation for the Financial Year 2008-09 (WDV Method)**						
3		**Year-Beg-Dt**	**01-Apr-08**		**Year-End**	**31-Mar-09**	
4	**Asset Name**	**Purchase Date**	**Installation Date**	**Purchase Cost**	**Installation Expenses**	**Pre-Operation Expenses**	**Cost to Use**
5	CNC Machine	11-Jul-08	17-Jul-08	877000	11000	3000	891000
6	Packing Machine	03-May-06	07-May-06	123000	8000	2500	133500

2	**Calculation of Depreciation for the Financial Year 2008-09 (WDV Method)**						
10	**Asset Name**	**Salvage Value**	**Life in Years**	**Period**	**Months in 1st Yr**	**Yr-End-Dt in 1st Yr**	**Depreciation**
11	CNC Machine	45000	7	1	9	31-Mar-09	231882.75
12	Packing Machine	17000	7	3	11	31-Mar-07	19433.37

Excerpts of the Spread sheet showing the depreciable amount

INTEXT QUESTIONS 36.4

State True or False :

i. In Straight Line Method, the amount of depreciation remain constant in all the years.

ii. In Diminishing Balance Method, the amount of depreciation is calculated at a fixed rate on the reducing book value of an asset.

iii. Rates of depreciation prescribed in the Companies Act, 1956 are same for all the methods of depreciation.

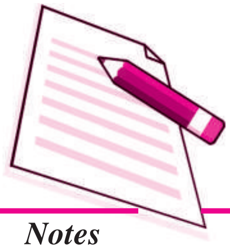
Notes

WHAT YOU HAVE LEARNT

- Use of computers for maintaining the records salary of employees is known as Payroll Accounting.
- Components of Pay Roll :
  - Basic Pay
  - Grade Pay
  - Dearness Allowance
  - House Rent Allowance
  - Transport Allowance
- Deductions from Pay
  - Professional Tax
  - Provident Fund
  - Tax Deduction at Source
  - Recovery of Loan Installment
- Pay of employees can be easily calculated and shown with the help of Payroll accounting.
- Depreciation is an allocation of the depreciable cost of a non-current (fixed) asset over its useful life.
- Excel worksheet supports the function of SLN (Straight Line), DB (Diminishing Balance), DDB (Double Declining Balance), SYD (Sum of Years Digit) to Compute Depreciation on Assets.

TERMINAL EXERCISE

1. What is Payroll Accounting?
2. Enumerate the components of Payroll Accounting.



Notes

3. Explain the various Earnings included in Payroll Accounting.
4. Explain the various items of deductions used in Payroll Accounting.
5. What is Depreciation?
6. Give the classification of Assets.
7. Which schedule of Companies Act, 1956 shows the rates of depreciation for different classes of assets?
8. Give the names of methods of depreciation supported by Excel worksheet.

ANSWERS TO INTEXT QUESTIONS

36.1 i. Monthly ii. Terms & Conditions of Employment

iii. House Rent

36.2 i. Basic Pay Earned ii. Dearness Allowance

iii. Transport Allowance iv. House Rent Allowance

v. Provident Fund vi. Tax Deducted at Source

36.3 i. Depreciation ii. Allocation iii. Sum of years digits

36.4 i. True ii. True iii. False

37

GRAPHS AND CHARTS

In the previous lesson, you have learnt about the basic features of spreadsheet and use of spreadsheet in accounting. Quite often, we have to present the data for communication of the accounting information. If mass of data is presented in the raw form, it may not be easily understandable. It can be said, .A picture is worth more than thousand words. In this lesson, we are discussing the methods of preparing graphs, charts and diagrams showing the data through the use of Excel as a tool.

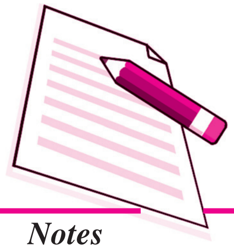
OBJECTIVES

After Studying this lesson, you will be able to:

- State the meaning of Graphs and Charts.
- Create a Chart on excel sheet.
- Modify a chart on Excel sheet.
- Understand the Chart Tools and their uses on Excel Sheet.
- Explain the advantages of using Charts and Graphs.

37.1 GRAPHS AND CHARTS

Graphs and Charts are pictorial representation of data, which has at least two dimensional relationship. Graphs, has two axes X and Y. X axis is usually horizontal while Y axis is vertical. Graphs/ Charts allow you to present information contained in the worksheet in a graphic format. Excel offers many types of charts including: Column, Line, Pie, Bar, Area, Scatter and more. To view the charts available click the Insert Tab on the Ribbon.



Notes

37.1.1 Using Charts/Graphs tools in Excel

Create a Chart

To create a chart:

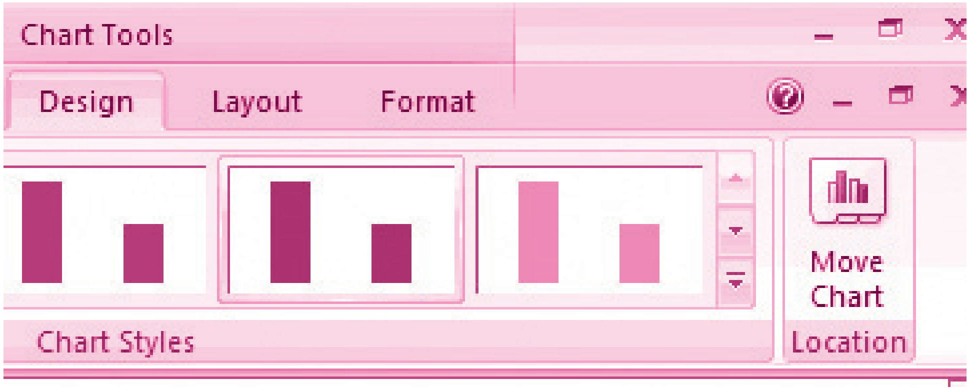
- Select the **cells** that contain the data you want to use in the chart
- Click the **Insert** tab on the Ribbon
- Click the type of **Chart** you want to create

37.1.2 Modify a Chart

Once you have created a chart you can do several things to modify the chart.

To move the chart:

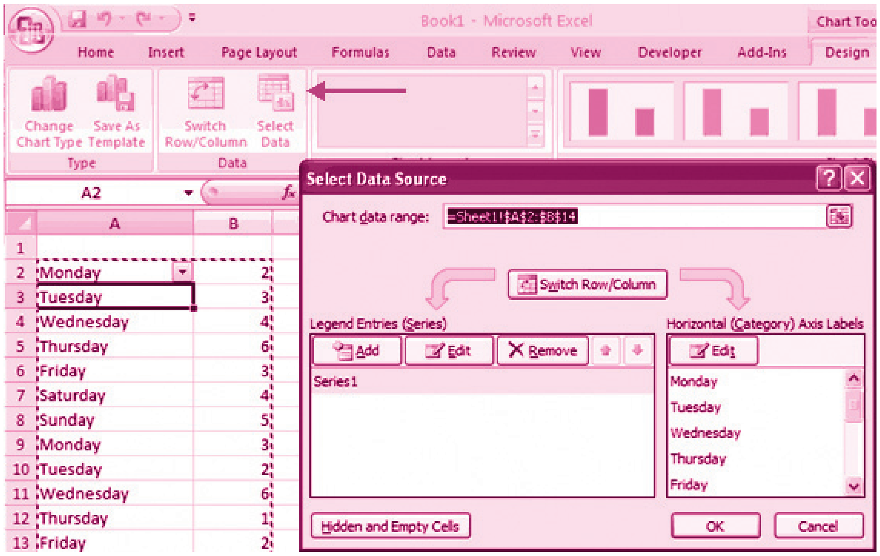
- Click the **Chart** and **Drag** it to another location on the same worksheet, or
- Click the **Move Chart** button on the **Design** tab
- Choose the desired location (either a new sheet or a current sheet in the workbook)



To change the data included in the chart:

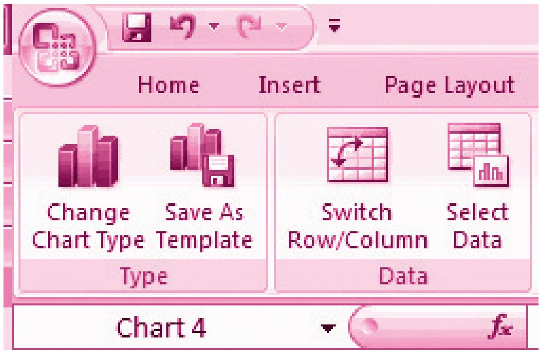
- Click the **Chart**
- Click the **Select Data** button on the **Design** tab

Notes



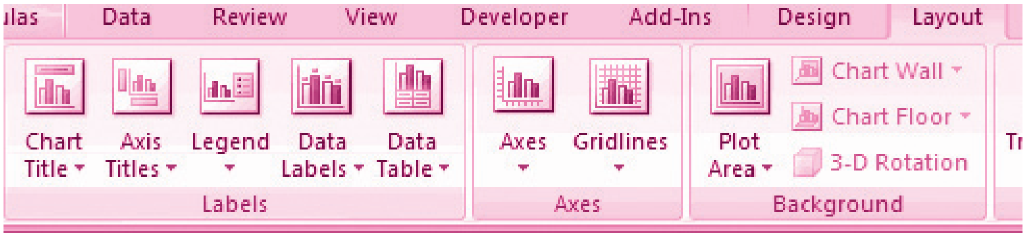
To reverse which data are displayed in the rows and columns

- Click the **Chart**
- Click the **Switch Row/Column** button on the **Design** tab



To modify the labels and titles:

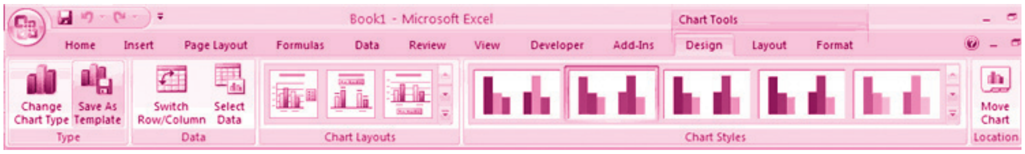
- Click the **Chart**
- On the **Layout** tab, click the **Chart Title** or the **Data Labels** button
- Change the **Title** and click **Enter**



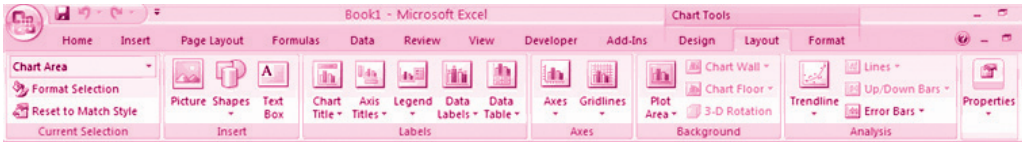
37.1.3 Chart Tools

The Chart Tools appear on the Ribbon when you click on the chart. The tools are located on three tabs: Design, Layout, and Format.

Within the **Design** tab you can control the chart type, layout, styles, and location.



Within the **Layout** tab you can control inserting pictures, shapes and text boxes, labels, axes, background, and analysis.



Within the **Format** tab you can modify shape styles, word styles and size of the chart.

37.1.4 Copy a Chart to Word

- Select the **chart**
- Click **Copy** on the **Home** tab
- Go to the **Word** document where you want the chart located
- Click **Paste** on the **Home** tab

INTEXT QUESTIONS 37.1

Fill in the blanks :

i. Graphs and Charts are ______________ representation of data.

ii. Graphs and charts have atleast ______________ dimensional relationship.

iii. X axis is usually ______________ while Y axis is ______________.

iv. To view the charts available, we have to click the ______________ tab on the ribbon.

37.2 ELEMENTS OF A CHART/GRAPH

A Chart/graph is a pictorial presentation of data. To understand and explain the chart/ graph we will learn all basic elements of the chart.

1. **The chart area :** The entire chart including all elements.
2. **The plot area:** In a 2-D chart, the area is bounded by the X and Y axis. In a 3-D chart, the area is bounded by the three (X, Y and Z) axis.
3. **The data points:** Individual values plotted in a chart and represented by bars, columns, lines, pie or various other shapes are called **data markers**. Data markers of the same colour constitute a **data series**. The data series are related **data points** that are plotted in the chart/ graph. Each data series in a chart is shown in a unique colour or pattern or both. Its identification is given by the legend. There may be more than one data series in a chart/graph.
4. **The horizontal (category) and vertical (value) axis :** The x-axis is usually the horizontal line which contains categories (independent values or categories) and y-axis is usually the verticals which contains data (dependent values).
5. **The legend :** It is an identifier of a piece of information shown in the chart/graph. The legends are assigned to the data series or different categories in a chart
6. **A chart and axes titles :** Descriptive text for chart title and axis title.
7. **A data label :** This provides additional information about a data marker to identify the details of data point in a data series. Some of the elements are displayed by default when we prepare the chart/graph; others can be added as needed. It is also possible to change the format or display of the chart/graph as desired.

37.3 FORMATTING OF CHART

Formatting the Chart (using design option)

Now, we will learn how the elements of a chart such as plot area, X-axis, Y-axis, data, titles, labels, legends and gridline can be formatted and edited as per the requirement. Click anywhere in the chart. This will display the **Chart Tools**, adding the **Design**, **Layout**, and **Format** tabs.Using **Design** option we can change the look of a chart. In the **Design** dialog box, we can click to change chart type, chart layouts and chart styles. One of the options provide for 2-d chart to swap the column data to row data and row data to column data.

The steps are as follows:

In a chart click the chart element to change, or do the following to select the chart element from a list of chart elements:

1. Click anywhere in the chart. This will display the **Chart Tools**, adding the **Design**, **Layout**, and **Format** tabs.
2. On the **Design** tab, in the **Data** group, click the arrow the **Switch Row/Column** box.

37.4 CHANGING THE FORMAT OF A SELECTED CHART ELEMENT

In the same chart, click the chart element to change, or do the following to select the chart element from a list of chart elements:

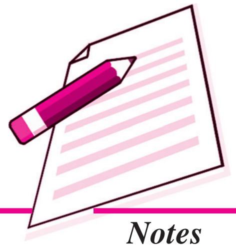
1. Click anywhere in the chart. This will display the **Chart Tools**, adding the **Design**, **Layout**, and **Format** tabs
2. On the **Format** tab, in the **Current Selection** group, click the arrow next to the **Chart Elements** box, and then select the chart element which requires to format.
3. On the **Format** tab, in the **Current Selecti1on** group, click the **Format Selection.**

e **Format <Chart Element>** dialog box, click a category, and then select the formatting options.

37.4.1 Changing the Shape Style

On the **Format** tab, in the **Shape Styles** group, do one of the following:

- To see all available shape styles, click the **More** button.
- To apply a pre- defined shape style, in the shape style box, click the style that we want.
- To apply a different shape fill, click **Shape Fill**, and then do one of the following:
  - To use a different fill Colour, under **Theme Colours** or **Standard Colours**, left click the select Colour.
  - To remove the Colour from the selected chart element, click **No Fill**.
  - To use a fill Colour that is not available under **Theme Colours** or **Standard colours** click **More Fill Colours**. In the **Colours** dialog box, specify the Colour that we want to use on the **Standard** or **Custom** tab, and then click **OK**. Custom fill Colours are added under **Recent Colours** can also be used.



Notes

- To fill the shape with a picture, click **Picture**. In the **Insert Picture** dialog box, click the picture to use, and then click **Insert**.
- To use a gradient effect for the selected fill Colour, click **Gradient**, and then under **Variations**, click the gradient style to be used. For additional gradient styles, click **More Gradients**, and then in the **Fill** category, click the gradient options that to use.
- To use a texture fill, click **Texture**, and then click the texture to use.

37.4.2 Changing the Shape Outline

To apply a different shape outline, click **Shape Outline**, and then do one of the following :

- To use a different outline Colour, under **Theme Colours** or **Standard Colours**, click the Colour to use.
- To remove the outline Colour from the selected chart element, click **No Outline**. If the selected element is a line, the line will no longer be visible on the chart.
- To use an outline Colour that is not available under **Theme Colours** or **Standard Colours** click **More Outline Colours**. In the **Colours** dialog box, specify the Colour that to use on the **Standard** or **Custom** tab, and then click **OK**. Custom outline colours are added under **Recent Colours** can be used again.
- To change the **weight** (thickness) of a line or border, click **Weight** option, and then select the line that we wish to use. For additional line style or border style options, click on **More Lines**, and then click the line style or border style options.
- To use broken line (dash. dash) or border, click **Dashes**, and then click the dash type to use. For additional dash-type options, click on **More Lines**, and then click the selected dash.
- To add arrows to lines, click **Arrows**, and then click the arrow style for borders cannot be used. For additional arrow style or border style options, click **More Arrows**, and then click the arrow setting.
- To apply a different shape effect, click **Shape Effects**, click a chosen effect, and then select the type of effect. The **shape effects** depend on the chart element that we select such as **Pre-set, reflection, and level.** The **shape effects** are not available for all chart elements.

37.4.3 Changing the Text Format

To format the text in chart elements, we can use regular text formatting options, or we can apply a **WordArt format**.

1. Click the chart element that contains the text to format.
2. Right-click the text or select the text to format, and then do one of the following:
   - Click the formatting options that we want on the **Mini toolbar**.
   - On the **Home** tab, in the **Font** group, click the formatting buttons that we want to use.

To use **WordArt styles** to **format text** use chart elements in the following steps:

1. In a chart, click the chart element that contains the text to be changed, or do the following to select the chart element from a list of chart elements:
2. Click anywhere in the chart.
3. This displays the **Chart Tools**, adding the **Design**, **Layout**, and **Format** tabs.
4. On the **Format** tab, in the **Current Selection** group, click the arrow next to the **Chart Elements** box, and then select the chart element that is to be formated.
5. On the **Format** tab, in the **WordArt Styles** group, do one of the following:

To see all available WordArt styles, click the **More** button. We get options for Text related formatting

- Text Fill
- Text Outline
- Shadow
- 3-D Format
- 3-D Rotation
- Text Box

37.4.4 Changing the Layout of the Chart Element

In the same chart, click the chart element to change, or do the following to select the chart element from a list of chart elements:

1. On the **Layout** tab, we can insert different Clip Arts, Picture, data labels, grids etc.
2. In the **Format <Chart Element>** dialog box, click a category, and then select the formatting options.

37.4.5 Change the Chart Type

A chart can be changed to another type of chart to get different look and purpose.

This is the easiest method to change from column chart or bar chart to Pie chart because

:

Only one data series is used to plot.:

- The plotted data values are positive.
- The data values are not equal to zero also.

Note that in Excel software Pie chart cannot plot more than seven catgories. The categories represent the parts of whole Pie.

Steps for creating a Pie Chart

1. Enter the data in a worksheet.
2. Select the data from two (consecutive) columns only.
3. Select the chart type Pie from the ribbon.
4. Under Pie types select 3-D Pie option
5. Click the plot of Pie chart. This displays the **Chart Tools**, adding the **Design, Layout**, and **Format** tabs.
6. On the **Design** tab, in the **Chart Layouts** group, select the layout to use.
7. On the **Design** tab, in the **Chart Styles** group, click the chart style.
8. On the **Format** tab, in the **Shape Styles** group, click **Shape Effects**, and then click **Bevel**.
9. Click **3-D Options**, and then under **Bevel**, click the **Top** and **Bottom** bevel options.
10. In the **Width** and **Height** boxes for **Top** and **Bottom** bevel options, type the point size.
11. Under **Surface**, click **Material**, and then click the material option.
12. Click **Close**.
13. On the **Format** tab, in the **Shape Styles** group, click **Shape Effects**, and then click **Shadow**.
14. Under **Outer**, **Inner**, or **Perspective**, click the shadow option.
15. To rotate the chart for a better perspective, select the plot area, and then on the **Format** tab in the **Current Selection** group, click **Format Selection**.
16. Under **Angle of first slice**, drag the slider to the degree of rotation that you want, or type a value between 0 (zero) and 360 to specify the angle of the first slice to

appear, and then click **Close**.

17. Click the chart area of the chart.
18. On the **Format** tab, in the **Shape Styles** group, click **Shape Effects**, and then click **Bevel**.
19. Under **Bevel**, select the bevel option.
20. To use theme colors that are different from the default theme that is applied the workbook, do the following:
    a. On the **Page Layout** tab, in the **Themes** group, **click Themes.**
    b. Under **Built-in**, click the theme to use.

37.4.6 Resizing of Chart/Graph

Resizing of the chart means changing size of the chart as desired. This option can be used independently for the **fonts, title, legends** easily. The first step is to select the chart by clicking the left button of the mouse. Move the cursor on the corners or middle of the borders of the chart/graph which will provide the figure (the cursor will take the shape of a two headed arrow). By pressing the left button, and drag/ pull as desired to resize the chart.

37.5 ADVANTAGES IN USING GRAPHs/CHARTs

1. **Help to Explore :** Many times we would like to see if there is a relationship between variables. Suppose that we wanted to determine if there is a relationship between: a country's GNP and the infant mortality rate, between age and between genders. It may be quicker and easier to create a chart immediately to see the possible relationship of variables to one another, rather than paging through raw data.
2. **Help to Present :** We want to provide information in as little time as possible. Graphing plays a key role. It seems that there is no longer any time to sit and read a newspaper in order to find out what is going on. However, newspapers, such as The Economics Times and India Today magazines (which were early users of charting techniques), seem to understand this phenomena and provide graphs to convey and sum up ideas that they are making in their articles.
3. **Help to Convince :** The same way that a graph can be used to present and explore different characteristics of data, it can also be used to convince. Graphs have the ability to take large amounts of information and make them into exhibitions that are easily used to persuade.

INTEXT QUESTIONS 37.2

Fill in the blanks with suitable word/words:

i. Plot area, X-axis, Y-axis, data, titles, labels, legends and gridlines are known as _______________ of a chart.

ii. To use a texture fill, we have to click _______________.

iii. A chart can be changed to another type of chart to get different look and _______________.

iv. In Excel software, Pie chart cannot plot more than _______________ categories.

WHAT YOU HAVE LEARNT

- A **graph** is a pictorial representation of data. Graphs are usually 2-dimensional. Sometimes 3-dimensional graphs are also used.
- A graph may be either a **singleline graph or a multi-line graph**. Multi-line in a graph are distinguished either by using different shapes of line or different shapes and colors.
- Other popular pictorial representations include **Pie Chart** and **Bar Chart**. Pie charts depict relative share of different elements. Bar charts are used to depict the comparison of absolute values of data (e.g. sales, production, etc.) at discrete points (e.g. time intervals, products, etc.).
- MS-Excel 2007 (or simply Excel) provides a convenient facility to draw graphs and charts. The nomenclature used in Excel for charts (charts include graphs) is as follows:

  a. The Chart Area,

  b. The Plot Area covering the plot of values in the selected type of chart,

  c. The Data Points,

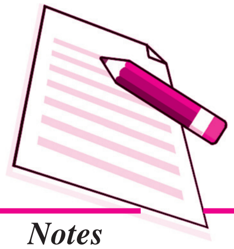
  d. The Horizontal (Base Values, e.g. category) and Vertical (Derived Values) Axes,

  e. The Legend to specify distinguishing criteria in case of multiple lines, pies, bars, etc.

  f. Chart and Axis Titles

  g. Data Labels

- Every element of a chart such as plot area, X-axis, Y-axis, **data, titles, labels,**



Notes

legends, and **gridlines** can be formatted using the Design, Layout and Format dialog box in Excel.

- Charts size can also be changed as per requirements.
- For multiple visualisations of the same data through different types of charts, we can change the chart type (say, from line graph to bar chart, or bar chart to pie chart, etc) wherever required for better presentation as per the nature of data.
- Graphs and charts help in easy visualisation of any trends present in data In highly random data such as stock prices, textual description may not be easily possible to explain the price or other fluctuations, but graphs and charts overcome this constraint as they can be comprehended more easily by human beings.

TERMINAL EXERCISE

1. Define charts, graphs and how they are useful in business decisions?
2. Write down the usage and purpose of column chart, pie chart and line chart.
3. Describe about data series, legend, and data labels??
4. Describe use of Excel for preparation of chart.
5. Differentiate between pie charts, line charts and column charts respectively?
6. Described the steps to move, resizing and reposition a chart.
7. What does percentage in chart represent and how it being calculated by the software?
8. What are the differences between
   a. Area, XY chart and doughnut
   b. 2-D Charts and 3-D Charts
9. What is pie chart and what are percentage values means in pie chart?
10. Explain different types of charts which can be prepared using Excel?

Multiple Choice Questions

1. To change the location of a chart, right-click the chart and select:

   a) Chart Type　　b) Source Data

   c) Chart Options　　d) Move here

2. The Ribbon allows us to:

   a) Create either an embedded chart or a chart sheet chart

b) Create only an embedded chart

c) Create only a chart sheet chart

d) Change the data values used to create the chart

3. Once we have created a chart we may change _____:

a) the formatting for text like titles and data labels

b) only by going back through the ribbon

c) everything about the chart

d) the data series patterns only

4. In Excel the chart tools provides three different options ______, ________ and _______ for formatting:

a) Layout, Format, Data Marker

b) Design, Layout, Format

c) Chart Layouts, Chart Style, Label

d) Format, Layout, Label

5. Pie chart don't have more than ________ categories:

a) Ten b) Twenty Five

c) Seven d) Three

6. Column charts are useful for ____________________:

a) Showing data changes over a period of time

b) Illustrating comparisons among items

c) Both a and b

d) None of the above

7. The 2D graph using _______ , _________ axes and in 3D graph ______ axis is also used.

a) Category, value, vertical b) Horizontal, vertical, depth

c) Category, value, series d) b and c both

8. Excel automatically redraws the chart ___________:

a) If any change is made in data b) If any change is made in the range data

c) a and b both d) None of the above

9. Legend can be repositioned on the chart:

a) anywhere b) on right side only

c) on the bottom of X-axis d) on the corner only

10. Which chart element details the data values and categories below the chart?

a) Data point b) Data labels

c) Data marker d) Data table

11. From what command tab is the font size for an axis in a chart changed?

a) Home b) Insert c) Format d) Design

12. Which of these purposes does not pertain to charts?

a) Identifying trends b) Selecting values

c) Recognising patterns d) Making comparisons

13. What do you see if you move over the mouse over a chart object?

a) KeyTip b) ScreenTip c) ChartTip d) ChartKey

14. Which group on the Chart Tools Format tab shows the name of the selected element?

a) Arrange Objects b) Chart Objects

c) Choose Selection d) Current Selection

Skill Review

A. Create a trend chart after filling data in to the worksheet.

(Population of India/State in Millions to be enter)

Year	*Male(1)*		*Female (2)*		*Total(3)*	
	Literate	*Illiterate*	*Literate*	*Illiterate*	*Literate*	*Illiterate*
2001						
2002						
2003						
2004						
2005						
2006						
2007						
2008						

Note: *Total Literate = Values of Male Literate + Values of Female Literate*

Total Illiterate = Values of Male Illiterate + Values of Female Illiterate

B. Create a Pie chart to compare data from above table for Total (column number 3).

C. Draw a Trend charts for each male, female and totals separately.

D. Draw a Column Chart for the above data for each (male, female and total)separately for Literate and Illiterate.

E. Prepare a Pie chart and Column chart for the 10 different plots areas 5, 7, 8, 9, 8, 10, 4, 6, 7 and 3 hectares respectively.

F. Draw a Pie chart for the following data on vehicles registered in the **RTO** department during 2007-08 in your city.

Vehicle Type	Bus	Trucks	Auto Rikshaw	Cars	Two Wheelers	Heavy Vehicles
Number of Vehicles	575	5889	12345	9765	23456	65

G. Draw a Column chart for the following data.

Marks	0-20	21-40	41-60	61-80	81-100	Total
Number of Students	13	180	350	232	125	1000

ANSWERS TO INTEXT QUESTIONS

37.1	i. Pictorial	ii. Two	iii. Horizontal, Vertical	iv. Insert
37.2	i. Elements	ii. Texture	iii. Purpose	iv. Seven

ANSWERS TO MCQ

1. d	2. d	3. a	4. b	5. c
6. c	7. c	8. c	9. a	10. b
11. a	12. b	13. c	14. d	

38

DATABASE MANAGEMENT SYSTEM

So far you have studied in the previous lessons as how Tally can be used as an Accounting software in present scenerio. You also learnt the steps in installation of computerised accounting system, and how a computer software can be used to create company. Together with this, once a company is created and entries are made, one is able to classify accounts in different groups & finally prepare the Trading & Profit and Loss A/c along with Balance Sheet. As you are well aware that the conventionally used paper filing system, text documents, and even spread sheets may not enough for the growing needs of tracking this data and critical information. A simple solution to this situation is available in the form of a Database management System (DBMS).

OBJECTIVES

After studying this lesson you will be able to :

- understand how to structure database as per requirement;
- design and create database tables;
- make use of Microsoft Access for simple database applications involving creation of back-end database and the front end forms for capturing, processing and
- retrieval of data

38.1 DEFINING DATABASE

A database is a collection of data for generating useful and decision worthy information. It consists of an organized collection of interrelated data for one or more users, in a digital form. We find several examples of databases in our daily life like a database for school or a bank, library, bus/railway reservation system etc. Database Management System offers a logical way of storing data in a systematic manner which overcomes

the several limitations such as data redundancy and inconsistency, data duplicity, difficulty in accessing data, data isolation, and data security problems. These difficulties, among others, prompted the development of database systems which represents data into the relational tables for the logical view of the database.

In order to understand how data is stored in a database to produce reliable and meaningful information, let us take an hypothetical case of an accounting database for maintaining data relating to accounting transactions of a business firm named Unique Electronics. The process of structuring a database comprises following elements:

38.1.1 Requirement Analysis

Requirements Analysis is the first and most important stage while designing a database. This stage involves assessing the informational needs of an organization, also referred to as Reality. The data requirements are used as a source for database design such as:

1. Data to be stored in the database.
2. Frequency of the data to be modified.
3. Users types of database.
4. Level of hardware and operating system available.
5. Will the database (back end) be used by any other front end application?

In our hypothetical case i.e., Unique Electronics, accounting transactions needs to be represented conceptually with full description i.e., accounting transactions are documented via vouchers. Voucher exhibits the date of transaction, amount of transaction, account name and account code (both for debit and credit entry) and the narration with respect to the transaction happened. Then the support documents are attached to the accounting voucher. The transactions are documented with respect to the category of accounts affected. These accounts are then classified into the categories (account types): Expenditure, Income, Assets, Liabilities and Capital.

38.1.2 Conceptual Design

After collecting and analyzing all requirements of an organization, a Conceptual diagram is developed for the database known as Entity-Relationship (ER) diagram. ER diagram consists of entities, the attributes related to these entities and their relationships. *Entity* is a real-world object, distinguishable from other objects. An entity is described using a set of *attributes*. An attribute is a property that describes an entity. *Relationships* are used to tie together different entities (two or more entities). Relationships can also have their own attributes.

38.1.3 Logical Design

It is representational data model through which ER design is transformed into inter-related data tables. Accordingly, there emerge five tables in our hypothetical case of Unique Electronics:

1. Employee Table
2. Vouchers Table
3. Support Table
4. Accounts Table
5. AccountType Table

38.2 IDENTIFICATION OF DATA TO BE STORED IN TABLES

Consider the following accounting transactions. Voucher number is coded sequentially.

1. Recall the journal entries recorded in case of manual system.

Date	*Voucher No*	*Transactions*	*Amount ₹*
April, 2014			
		Commenced business with cash:	
01	A1	Sanjana	5,00,000
01	A2	Naveen	4,00,000
01	A3	Cash deposited into Bank	4,00,000
02	A4	Goods purchased from Jain and payment made by Cheque No. : 765421	1,50,000
02	A5	Paid for Carriage to M/s Sonu Transports	200
04	A6	Goods sold to Kripa & Co.	1,75,000
05	A7	Goods purchased from M/s Jyoti Bros.	2,50,000
06	A8	Sold goods for cash to M/s Kansakar & Co.	45,000
08	A9	Paid for advertisement by Cheque No.: 765424 to m/s Cosmo cables	2,500
09	A10	Received Bill of Exchange from Kripa & Co. Payable after 3 months	1,75,000
17	A11	Paid for insurance of godown Cheque No.: 765425	5,500
18	A12	Paid for Fuel, Power and Electricity	1,000

23	A13	Cash withdrawn by Sanjana for household expenses	20,000
27	A14	Goods taken from stock for personal use by Sanjana	5,000
28	A15	Furniture purchased from M/s S.N. Furniture by Cheque No.: 765428	45,000
30	A16	Salary for the month paid by cheque to Ramaiya	9,000
30	A17	Payment of Telephone bill by Cheque No.: 765433	1,500
30	A18	Paid for wages by cash	7,000

2. The individual accounts affected by these transactions are grouped under five categories :

    Capital ……………………….....…….... 5

    Liabilities ………………………....….... 4

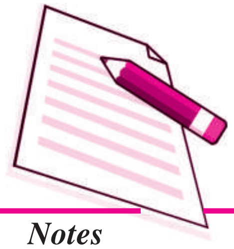
    Assets………………………………......... 3

    Revenue ……………………………..........2

    Expenditure…………………….............1

3. Based upon these account groups, the transactions are to be analysed. Later, the chart of accounts is subjected to the scheme of codification. In this case, the individual accounts are grouped as follows:

Account Name	*Acc_Type*
Sanjana's Capital Account	5
Naveen's Capital Account	5
Jyoti Bros.	4
Sanjana's Drawings	4
Naveen's Drawings	4
Furniture	3
Office Fittings	3
Plant and Machinery	3
Kripa & Co.	3

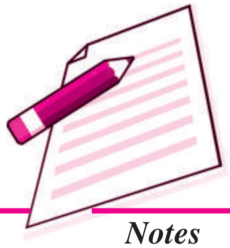


Notes

Cash	3
Bank	3
Bills Receivable	3
Sales	2
Purchases	1
Carriage Inwards	1
Fuel, Power and Electricity	1
Wages	1
General Expenses	1
Rent	1
Salaries	1
Discount Allowed	1
Advertisement	1
Insurance	1

4. The coding scheme of accounts, in this case, is as follows.

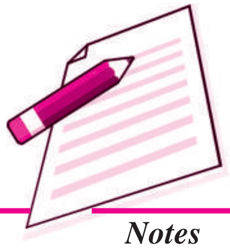
First Digit of Account_code	
Categories	
05	Capital
04	Liabilities
03	Assets
02	Revenue
01	Expenditure
Second Digit of Account_code	
Under Capital (5)	
01	Sanjana's Capital
02	Naveen's Capital
Under Liabilities (4)	



Notes

Second Digit of Account_code	
Long term Liabilities (41)	
Third Digit of Account_code	
01	—
02	—
03	—
Current Liabilities (43)	
Third Digit of Account_code	
01	Jyoti Bros.
10*	Sanjana's Drawings
This gap in code is provided for flexibility, based on the accounting concept that the business will survive and expand for the years to come.	
11	Naveen's Drawings
13	—
15	—
20	—
Under Assets (3)	
Second Digit of Account_code	
Fixed Assets (31)	
Third Digit of Account_code	
01	Furniture
02	Office Fittings
03	Plant and Machinery
04	—
05	—
06	—
Current Assets (32)	

Third Digit of Account_code	
11	Kripa & Co.
15*	Cash
16	Bank
17	Bills Receivable
This gap in code is provided for flexibility, based on the accounting concept that the business will survive and expand for the years to come.	
Under Revenue (2)	
Second Digit of Account_code	
01	Sales
Under Expenses (1)	
Second Digit of Account_code	
Capital Expenditure (11)	
Third Digit of Account_code	
01	=
02	=
03	=
Revenue Expenditure (12)	
Third Digit of Account_code	
01	Purchases
02	Carriage Inwards
03	Fuel, Power and Electricity
04	Wages
10	General Expenses
16	Rent
19	Salaries
24	Discount Allowed
27	Advertisement
29	Insurance



Notes

5. The above codification scheme utilizes the hierarchy used in grouping of accounts. Let us, for example, assume that our hypothetical case adopts a code range of 4 digits. In such a case, the codes will be assigned to the account heads in the following manner. (This may also be noted that we are using these 4 digit account codes for our data base design).

Account_code	*Account Name*
5001	Sanjana's Capital Account
5002	Naveen's Capital Account
4301	Jyoti Bros.
4310	Sanjana's Drawings
4311	Naveen's Drawings
3101	Furniture
3102	Office Fittings
3103	Plant and Machinery
3211	Kripa & Co.
3215	Cash
3216	Bank
3217	Bills Receivable
2001	Sales
1201	Purchases
1202	Carriage Inwards
1203	Fuel, Power and Electricity
1204	Wages
1210	General Expenses
1216	Rent
1219	Salaries
1224	Discount Allowed
1227	Advertisement
1229	Insurance

STRUCTURING OF DATA IN DATABASE

Accounts Table

Code	*Account Name*	*Acc_Type*
5001	Sanjana's Capital Account	5
5002	Naveen's Capital Account	5
4301	Jyoti Bros.	4
4310	Sanjana's Drawings	4
4311	Naveen's Drawings	4
3101	Furniture	3
3102	Office Fittings	3
3103	Plant and Machinery	3
3211	Kripa & Co.	3
3215	Cash	3
3216	Bank	3
3217	Bills Receivable	3
2001	Sales	2
1201	Purchases	1
1202	Carriage Inwards	1
1203	Fuel, Power and Electricity	1
1204	Wages	1
1210	General Expenses	1
1216	Rent	1
1219	Salaries	1
1224	Discount Allowed	1
1227	Advertisement	1
1229	Insurance	1

AccounttypeTable

Cat_Id	*Category*
5.	Capital
4.	Liabilities
3.	Assets

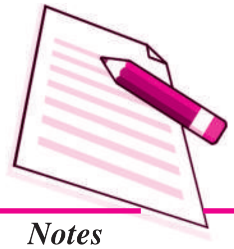
Notes

2.	Income
1.	Expenses

Vouchers Table

V_no	*Debit*	*Amount*	*Vdate (MM/DD)*	*Credit*	*Narration*
A1	3215	5,00,000	04/01	5001	Sanjana commenced business with cash
A2	3215	4,00,000	04/01	5002	Naveen commenced business with cash
A3	3216	4,00,000	04/01	3215	Deposited into bank
A4	1201	1,50,000	04/02	3216	Purchased goods through bank
A5	1202	200	04/02	3215	Carriage inward paid
A6	3211	1,75,000	04/04	2001	Sold goods to Kripa & Co.
A7	1201	2,50,000	04/05	4301	Purchased goods from Jyoti Bros. On credit
A8	3215	45,000	04/06	2001	Sold goods for cash
A9	1227	2,500	04/08	3216	Advertisement expenses paid through bank
A10	3217	1,75,000	04/09	3211	B/R received
A11	1229	5,500	04/17	3216	Insurance paid through bank
A12	1203	1,000	04/18	3215	Electricity charges paid in cash
A13	4310	20,000	04/23	3215	Sanjana's drawings
A14	4310	5,000	04/27	1201	Goods taken for personal use by Sanjana
A15	3101	45,000	04/28	3216	Furniture purchased through bank
A16	1219	9,000	04/30	3216	Salary paid through bank
A17	1210	1,500	04/30	3216	Telephone bill paid through bank
A18	1204	7,000	04/30	3215	Wages paid in cash

Note : The employees table and support table omitted.



Notes

INTEXT QUESTIONS 38.1

Fill in the blanks with appropriate words :

i. ______________ is the first and most inportant stage while designing database.

ii. ______________ are used to be together different entities.

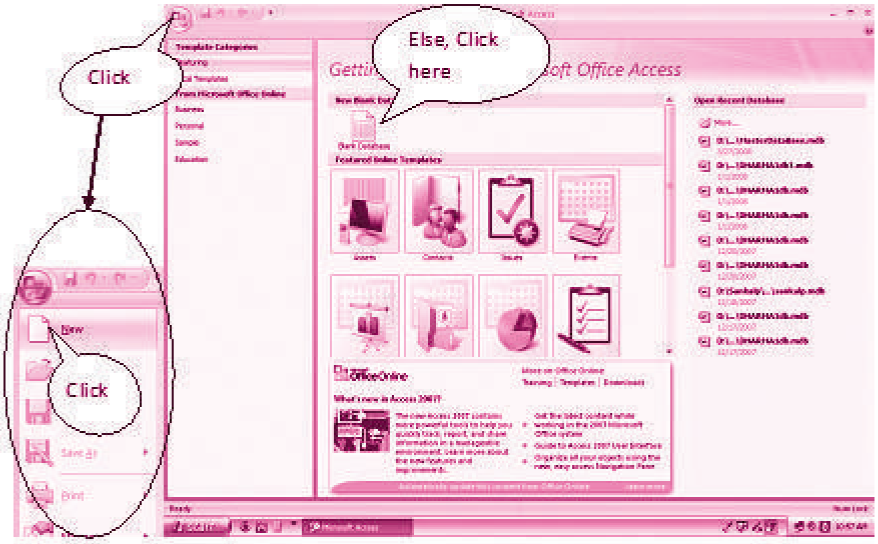
iii. All the accounts can be grouped in __________________ categories.

38.3 MICROSOFT ACCESS - INTRODUCTION

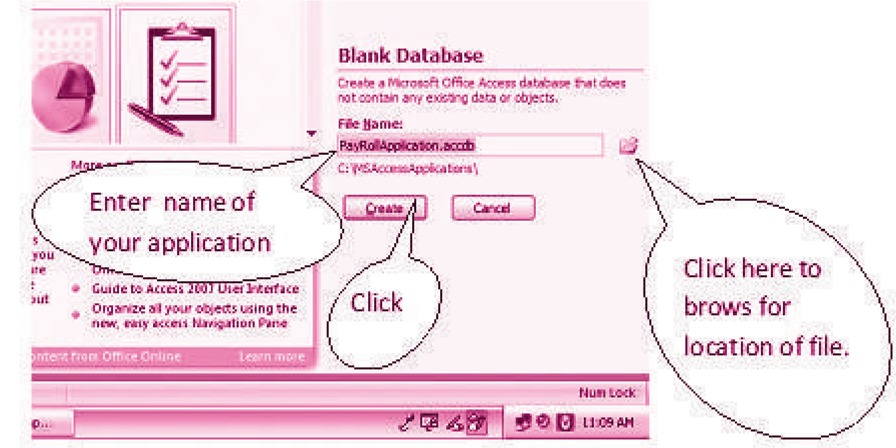
MS Access is one of the popularly used Data Base Management System to create, store and manage database. Access has certain capabilities, which bring it closer to an ideal Data Base Management System (DBMS). Before we take up the task of database design using Access, we will have to first start up the Microsoft Access Application:

Start > All Programs > Microsoft Office > Microsoft Access 2007

Tables, Queries, Forms and Reports are main components of MS Access. Others being Pages, Macros and Modules. The *Table object* enables the designer to create data tables with their respective fieldnames, data types and properties. *Queries* are meant to create the SQL compatible query statement, store data and retrieve both data and information. *Forms object* creates an appropriate user interface to formally interact with the back end database, defined by tables and queries. *Report object* is used to create various reports as per the requirement of the end user. The following pages take you through the graphics on how to start and work on MS Access-2007.



Getting Started with Microsoft Office Access



Dialogue Box for Creating New Database File

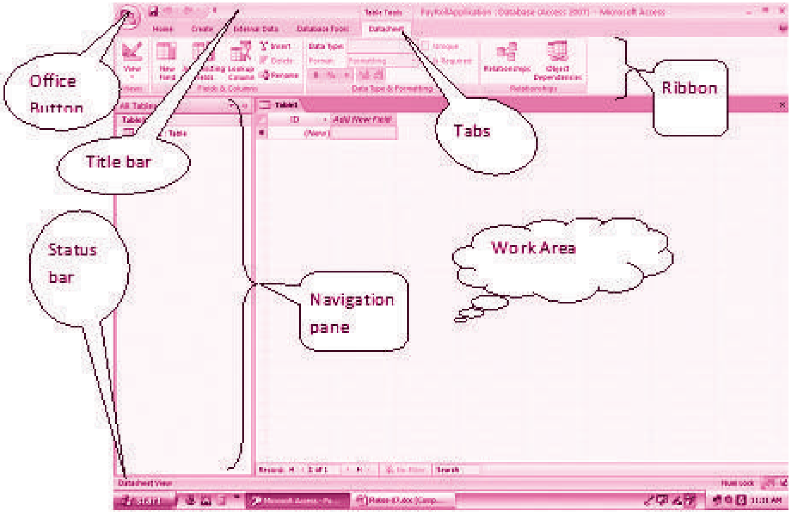
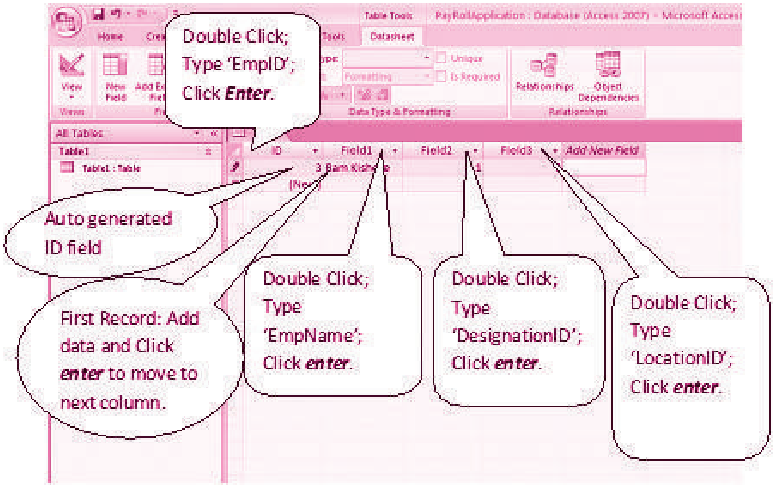
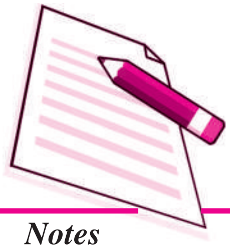


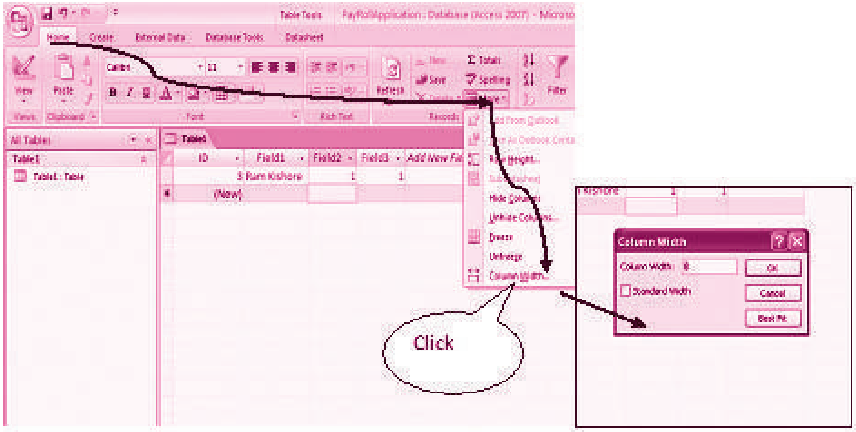
Illustration of the Active Database Window



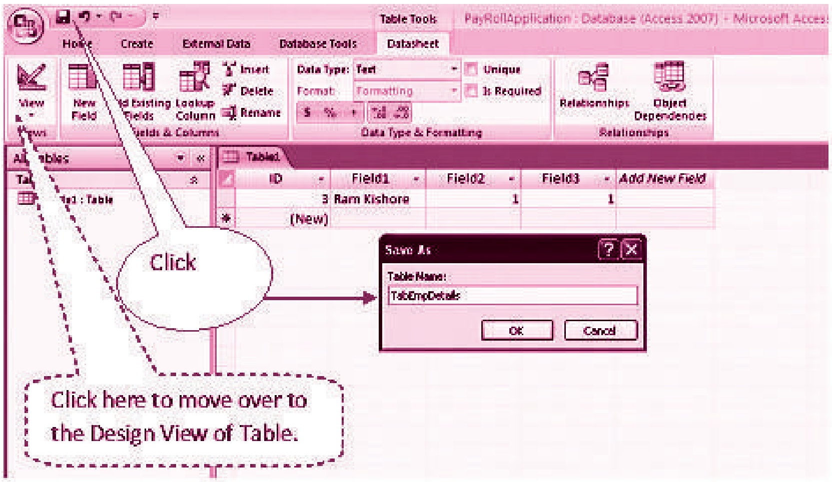
Creating a Table by Adding Records



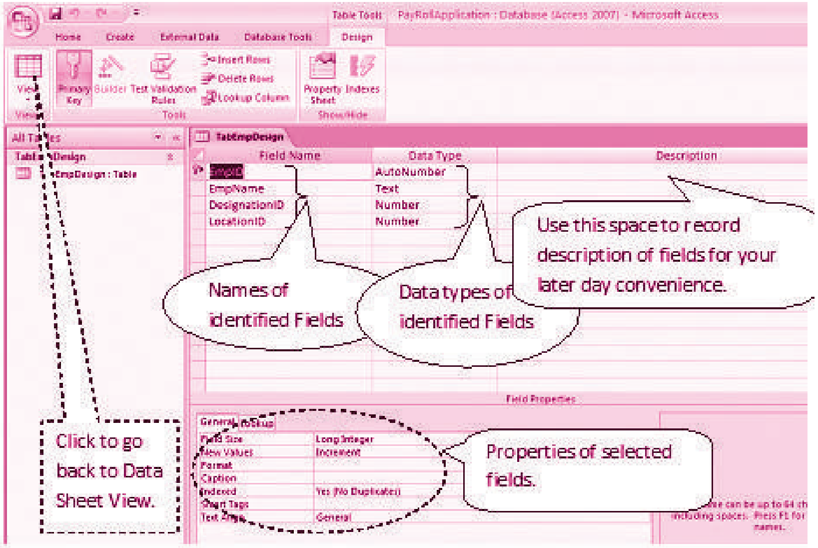
Notes



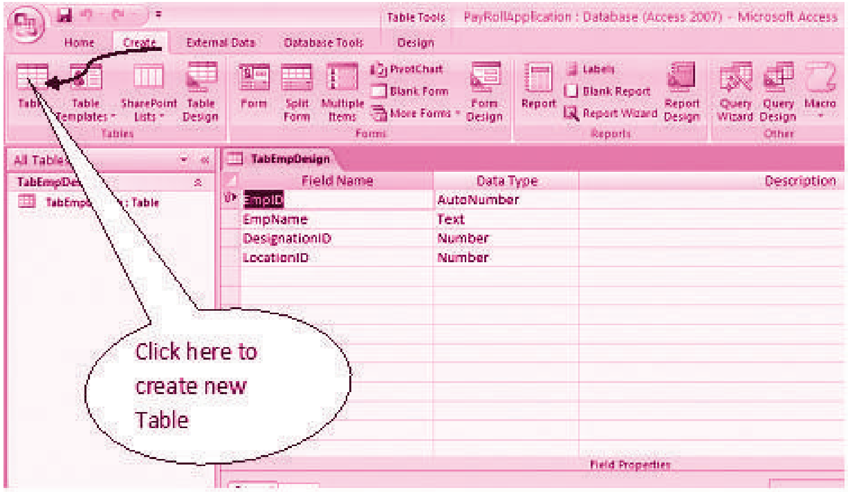
Column width Adjustment



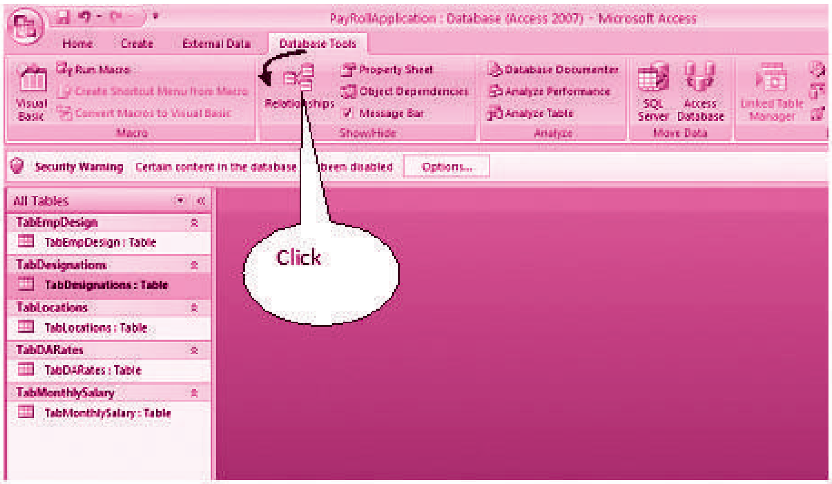
Saving of the Table with intended Name



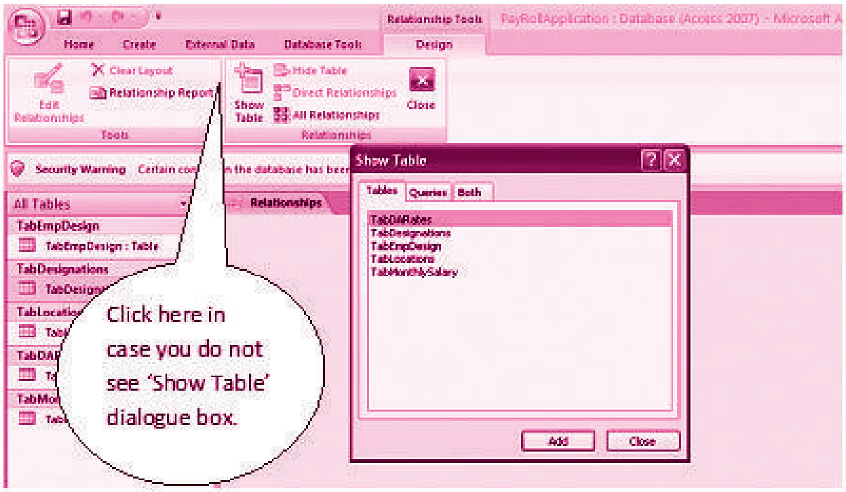
Design View of the Table



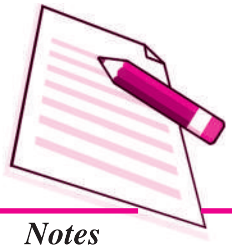
Creating New Table



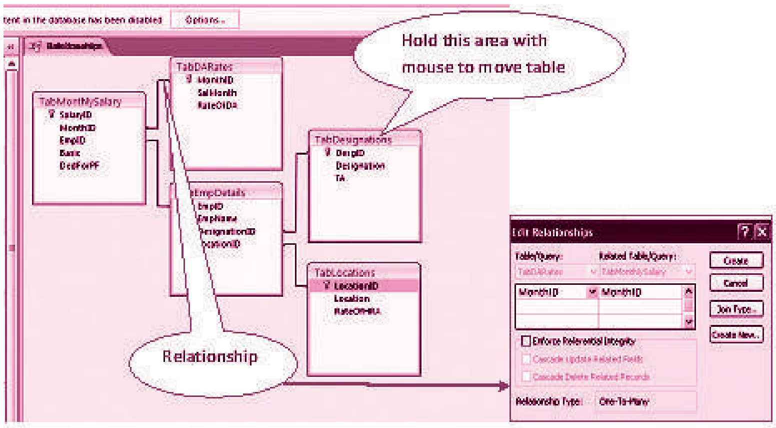
Creating Relationship between Tables



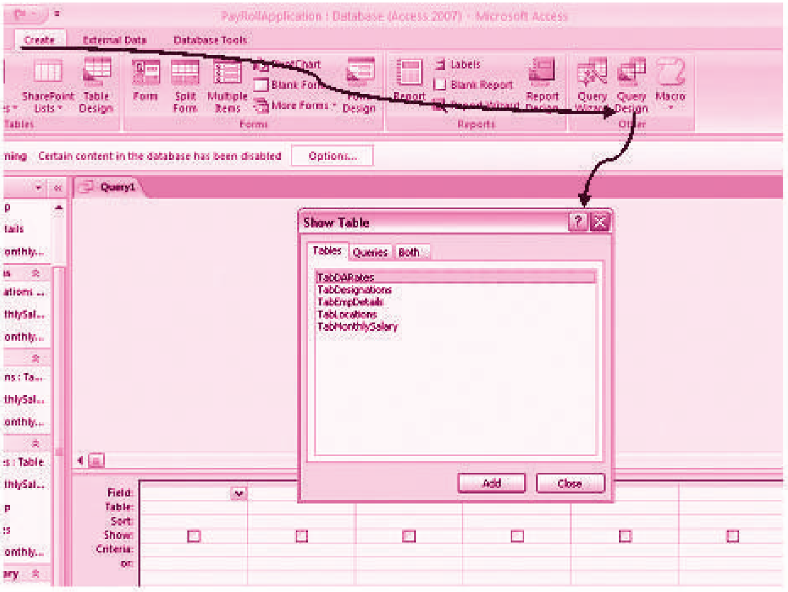
Adding of Tables for establishing relationship between them



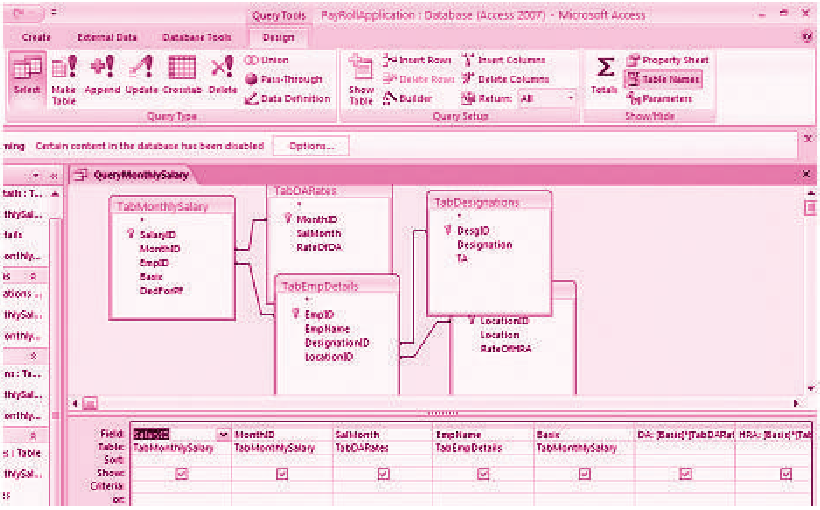
Notes



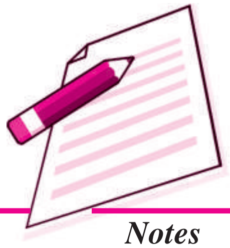
Relationship between different Tables



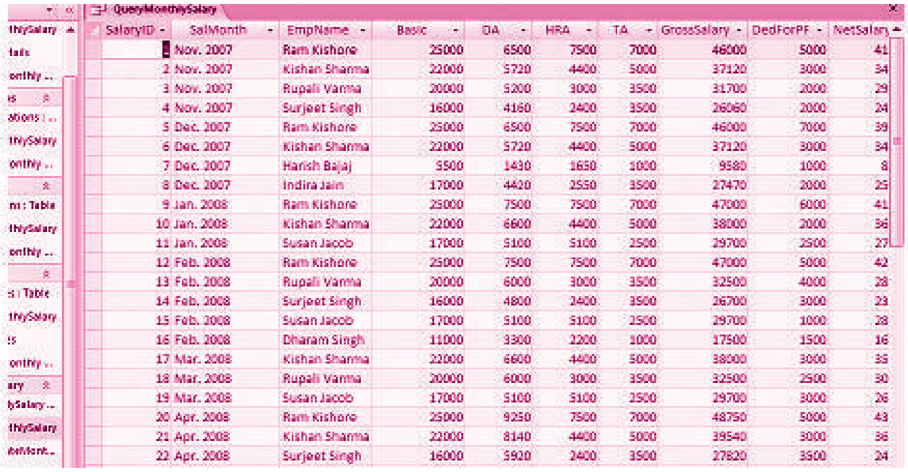
Creation of Query



Creation of different Fields in the Query Table



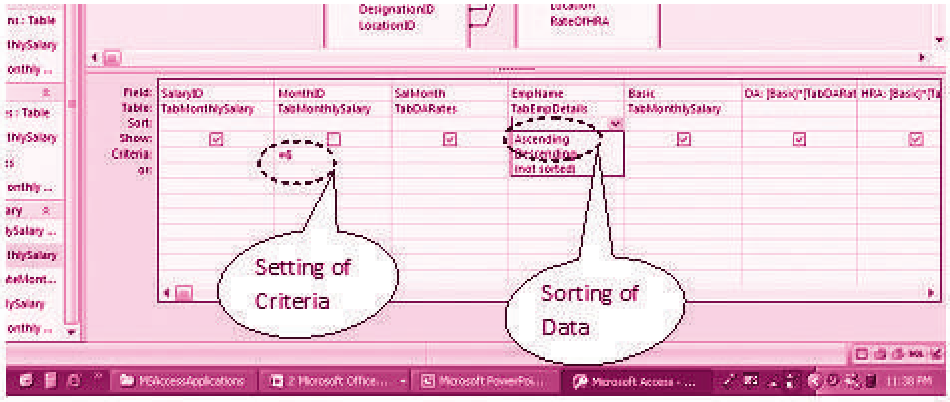
Notes



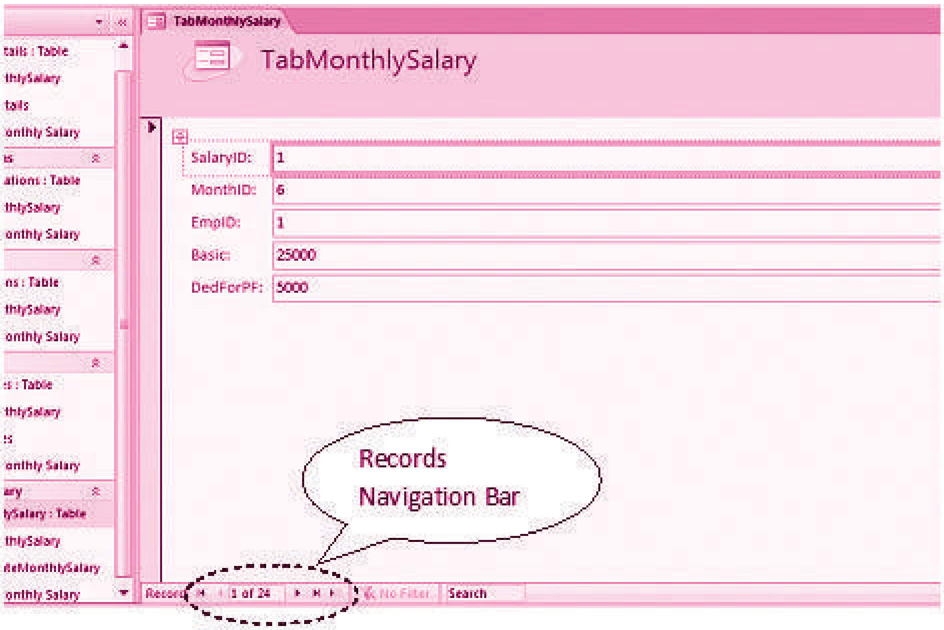
QueryMonthlySalary

SalaryID	SalMonth	EmpName	Basic	DA	HRA	TA	GrossSalary	DedForPF	NetSalary
1	Nov. 2007	Ram Kishore	25000	6500	7500	7000	46000	5000	41
2	Nov. 2007	Kishan Sharma	22000	5720	4400	5000	37120	3000	34
3	Nov. 2007	Rupali Varma	20000	5200	3000	3500	31700	2000	29
4	Nov. 2007	Surjeet Singh	16000	4160	2400	3500	26060	2000	24
5	Dec. 2007	Ram Kishore	25000	6500	7500	7000	46000	7000	39
6	Dec. 2007	Kishan Sharma	22000	5720	4400	5000	37120	3000	34
7	Dec. 2007	Harish Bajaj	5500	1430	1650	1000	9580	1000	8
8	Dec. 2007	Indira Jain	17000	4420	2550	3500	27470	2000	25
9	Jan. 2008	Ram Kishore	25000	7500	7500	7000	47000	6000	41
10	Jan. 2008	Kishan Sharma	22000	6600	4400	5000	38000	2000	36
11	Jan. 2008	Susan Jacob	17000	5100	5100	2500	29700	2500	27
12	Feb. 2008	Ram Kishore	25000	7500	7500	7000	47000	5000	42
13	Feb. 2008	Rupali Varma	20000	6000	3000	3500	32500	4000	28
14	Feb. 2008	Surjeet Singh	16000	4800	2400	3500	26700	3000	23
15	Feb. 2008	Susan Jacob	17000	5100	5100	2500	29700	1000	28
16	Feb. 2008	Dharam Singh	11000	3300	2200	1000	17500	1500	16
17	Mar. 2008	Kishan Sharma	22000	6600	4400	5000	38000	3000	35
18	Mar. 2008	Rupali Varma	20000	6000	3000	3500	32500	2500	30
19	Mar. 2008	Susan Jacob	17000	5100	5100	2500	29700	3000	26
20	Apr. 2008	Ram Kishore	25000	9250	7500	7000	48750	5000	43
21	Apr. 2008	Kishan Sharma	22000	8140	4400	5000	39540	3000	36
22	Apr. 2008	Surjeet Singh	16000	5920	2400	3500	27820	3500	24

Datasheet View of the Query



Seeting of Criteria and Sorting of Data in a Query



Creation of Form

INTEXT QUESTIONS 38.2

Fill in the blanks :

i. _______________ are meant to create the SQL compatibel query statement, store data and retrieve both data and information.

ii. _______________ is used to create various reports as per the requirement of the end user.

iii. _______________ has certain capabilities, which bring it closer to an ideal Database Management System.

38.4 CREATING TABLES IN ACCESS

Follow the following steps to create Tables in Access

1. Click at *Tables* object of Access followed by double click at create *table by design view*. A table window appears which has three columns: Field Name (*refers to the column name of the table being created*.), Data Type (*attribute of each defined column, refer figure 2*) and Description (*It is optional and the designer can provide description of the column for clarity.)*. Here you define the structure of the Table.

Text	It is used for a string of characters i.e., words or numbers not subjected to any kind of arithmetical calculations. The maximum length for a text field is 255 characters.
Memo	Used for storing comments and accommodates 65,536 characters.
Number	*Stores numbers and are subjected to arithmetical calculations.*
Date/Time	Stores dates, times or a combination of both.
AutoNumber	*It is a numeric data automatically entered by Access.*
Currency	Stores numbers in terms of Dollars, Rupees or other currencies.
Yes/No	Declares a logical field which may have only one of the two opposite values alternatively given as Yes or No.
OLE object	Stands for Object Linking and Embedding, Refers to object such as photograph, bar code, image or any other document created in another application.
Hyperlink	This data type stores Universal Resource Locator (URL) and email addresses.

2. Once the data types is specified, Access allows designer to define properties of each column. In the context of text data type, the general properties relate to:

Field size	Refers to the maximum number of characters allowed in each column. In case of numbers, it refers to the type of numbers being stored as per the requirements.
Format	Indicates as to how the field's contents are displayed.
Decimal places	Applies to single, double or decimal types of numbers.
Input mask	Formats data entry that includes punctuation. It works only for text and date type fields.
Caption	It is a label used for the field in datasheet and on forms and reports.
Default value	It is used for specifying a value for new entries of data records.
Validation rule and text	Checks data to eliminate incorrect entries. Validation criteria is specified for this property. If the entered data does not satisfy the validation criteria, the validation message is displayed.
Required and Indexed	Required property must be provided value Yes/ No. Indexing a field results in speeding up sorting, searching and filtering of records on that field.
Allow zero length	This property is available only for text fields. Setting it to Yes/No determines whether a text string with zero length is a valid entry or not.

INTEXT QUESTIONS 38.3

Fill in the blanks :

i. Memo is used for storing comments and accommodates ___________ characters.

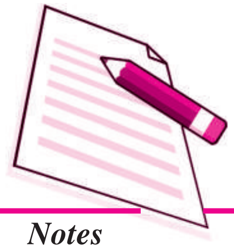
ii. OLE object stands for _____________.

iii. _______________ formats data entry that includes punctuation. It works only for text and date type fields.

iv. _____________ is a label used for field in datasheet vie and on forms and reports.

Skill Review 1

1. Adjusting Column Widths; Finding and Editing Records; Adding and Deleting Records



a) Start Access and open the Employee1.accdb database.

b) Create Employees table.

c) Adjust all columns to Best fit.

d) Fill in the table with data.

e) Use FIND command to locate the records. Edit Salary, Date of Birth, Hire Date.

f) DELETE record.

g) Add new records to the table.

2. Sorting and Filtering

a) With Employee1.accbd file, open the employees table.

b) Sort the table in ascending order by Last_Name.

c) Sort the table in descending order by Annual_Salary.

d) Sort the table in ascending order first by Department and then by Last_Name.

e) Preview the table in the Print preview window.

f) Filter table to display only those employees who work in the European distribution department.

g) Close the database.

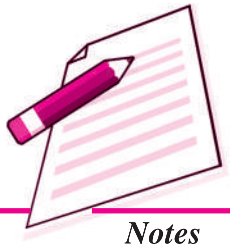
3. Mr. Jai Prakash, instructor in the Theatre Arts Division, has been called out of town to attend a family matter. The grades for Middle semester II have to be entered into the database by the end of the today. Jai has provided you with the following grades:

Seema	A+	Kavita	C
Meena	C	Asha	A
Sarika	B+	Babita	B+
Aashita	D	Jaya	A
Tannu	C	Mamta	B
Susan	A+	Richa	C+

To Do:

a) Open Grades 1.accdb database.

b) Create Middle semester II table



c) Adjust column widths to *Best fit*.

d) Enter the grades provided in Step1 in the appropriate columns.

e) Preview table.

f) Close the table.

g) Close the database.

4. Creating the Job Search Company Database

a) You are starting to plan for your job search after graduation. You decide to maintain a database of company information in Access.

b) Search the Internet for at least eight companies in your field of study. Include company name, address, telephone and fax numbers and a contact person in their human resource department, if possible.

c) Open jobsearchcompanyinfo.accdb database.

d) Open the companyinformation table.

e) Enter at least eight records for the companies you researched on the internet.

f) Adjust column widths as necessary.

g) Sort the records in ascending order by the company name field.

h) Preview the table.

i) Format all records to a smaller font size.

j) Change the page layout to fit the table on one page.

k) Save the file.

l) Close the database.

5. Create Employee2.accdb database and enable content.

a. Create a table .Enter the following details:

Field Name	**Data Type**
Employee_No	Text
Supervisor_LastName	Text
Supervisor_FirstName	Text
Annual_Review_Date	Date/Time
Salary_Increment_Date	Date/Time
No_Teaching_Periods	Number

b. Define Employee_No as the primary key field.

c. Save the table and name it Annual_Review

d. Switch to Datasheet view and then enter the following two records:

Field Name	Data Value1	Data Value 2
Employee_No	1015	1030
Supervisor_LastName	Sharma	Gupta
Supervisor_FirstName	Anand	Dipankar
Annual_Review_Date	5/20/09	1/23/09
Salary_Increment_Date	7/01/09	3/02/09
No_Teaching_Periods	2	10

1. Adjust all columns to Best fit.
2. Save changes to the datasheet layout.
3. Switch to design view and then make the following changes to the field properties:
   a. Change the field size for the *Employee_No* to 4.
   b. Create a validation rule for the *No_Teaching_Periods* field to ensure that no number is greater than 10 is entered into the field. Enter an appropriate validation text error message.
   c. Save the table, click yes at each message that indicates same data may be lost, and test data with new validation rule.
   d. Save the table. Switch to data sheet view and add the following two records.

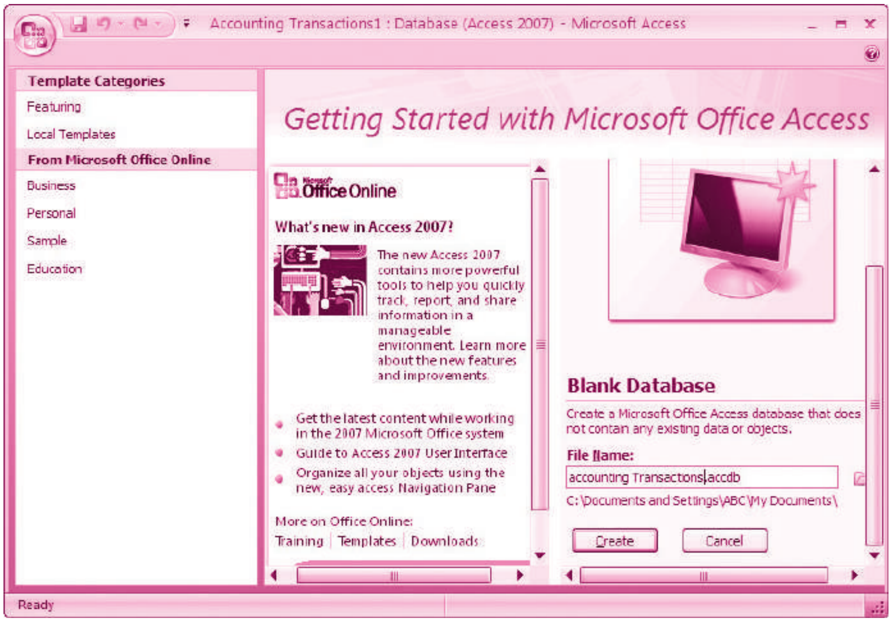
Field Name	Data Value1	Data Value 2
Employee_No	1035	1040
Supervisor_LastName	Faroqui	Jacob
Supervisor_FirstName	Samaira	Ann
Annual_Review_Date	14- March-09	10-March-09
Salary_Increment_Date	01-May-09	01-May-09
No_Teaching_Periods	8	6

4. Display the datasheet in print preview.
5. Change page orientation to landscape.
6. Close print preview and close Annual _Review table.

38.5 CREATING ACCOUNTING DATABASE FOR UNIQUE ELECTRONICS (USING MS ACCESS- 2007)

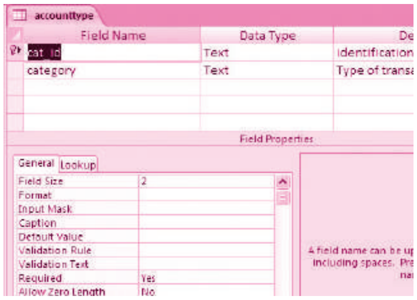
Using our conceptual design for Unique Electronics, we will now design a database for recording accounting transactions.

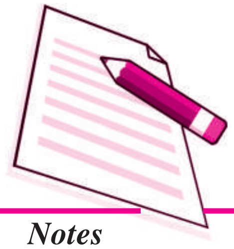
1. Create file Accounting Transaction



2. Create Table1, Table 2 and Table 3 and save as Account type, Accounts and Vouchers respectively.

3. In the design view, define the data fields as shown below:

Table: Accounts Field 1: code [Primary key, Text] Field 2: acc_name [Text] Field 3: acc_type [Number]	
Table: Account type Field 1: cat_id [Number] Field 2: category [Text]	



Notes

Table: Vouchers

Field 1: v_no	[primary key, Text]
Field 2: v_date	[Text]
Field 3: dr_code	[Number]
Field 4: cr_code	[Date/Time]
Field 5: dr_acc_name	[Text]
Field 6: cr_acc_name	[Text]
Field 6: Narration	[Text]
Field 7: Amount	[Number]

4. Fill in the data in the tables.

Vouchers | Accounts | AccountType

Code	Acc_Name	Acc_Type
1201	Purchases	1
1202	Carriage Inwards	1
1203	Fuel, Power and Electricity	1
1204	Wages	1
1210	General Expenses	1
1216	Rent	1

Vouchers | Accounts |

Cat_Id	Category
1	Expenses
2	Income
3	Assets
4	Liabilities
5	Capital

Vouchers | Accounts | AccountType

Vno	Debit	Amount	Date	Credit	
A1	3215	500,000	01-Apr-12	5001	Sar
A10	3217	175,000	09-Feb-12	3211	B/F
A11	1229	5,500	17-Feb-12	3216	Ins

Access basics for creating Forms

A Form in Access is designed for data entry, display of data stored in database, editing existing data and adding new data records.

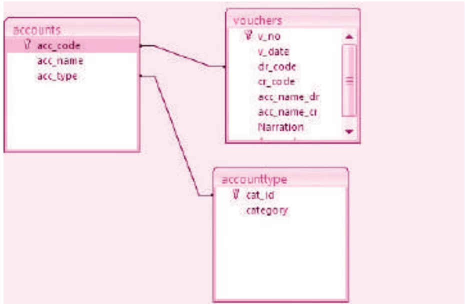
- Data Entry: Form is used for entering, editing and displaying data
- Application flow: Forms are used for navigating through an application.
- Printing information: It can be used for providing hard copies of data entry information.

5. Establish a relationship between tables.

   Having completed the designs of all data tables, the relationships are established between different tables.

   Click at: ***Database tools*** → ***Relationships*** → ***Show/Hide***

   In the **Show Table** dialog box, select a table and click ***Add***. Add all the tables in the relationship window and close the box by clicking ***Close*** button. In the working area, all the tables will be shown along with their defined field names.



6. Create query and Generate Reports

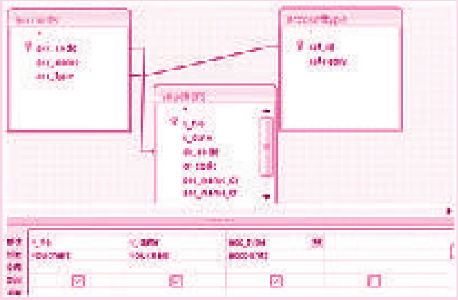
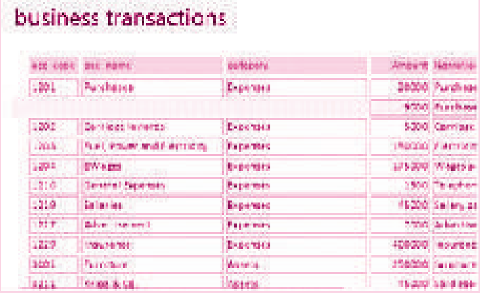
   Query provide real power to a database in terms of its capabilities to respond to user requests. In case of Access, Queries combines data from multiple tables and placing specific conditions for the retrieval of data.

   Click on : ***Create*** → ***Query Design***

   A ***Show Table*** dialog box appears with a ***Query Table*** in the back ground. In the Show Table dialog box, select a table and click ***Add*** button to add it in the relationship window. Close the show Table dialog box by clicking ***Close*** button. In the working above ***the Query Table*** you will notice the table objects with complete list of their fields along with the relationships established earlier. In the portion below the Table object, you will see the blank columns that represent columns in the query results datasheet, also called ***Design Grid***. Carefully fill different fields from Table object into the design grid in the same order in which we want to display in our query results.

Click : ***Run*** button under ***Results*** group of ***Design*** Tab to see the query results.

An accounting system without reporting capability is incomplete. Reporting is one of the main objectives for which an accounting system is designed, implemented and operated. There are two formats of presenting information through reports: Columnar and Tabular. Columnar and tabular format displays the caption of each field on a separate line in a single column down the page. A tabular format displays the caption of fields on the same line so that respective information contents appear in the next line.

Creation of queries	*Accounting reports*
	

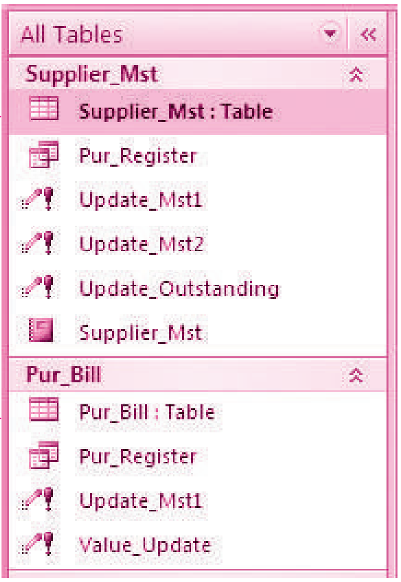
Skill Review 2

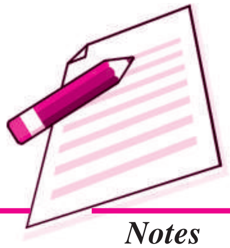
Accounting Tasks for preparing Purchase Journal for an organisation

I Preparation of purchase journal: conceptual design

Step 1: Create Tables

Table 1: Supplier_Mst		
Sup_code [Primary Key]	Number	
Sup_name Text	25	
Tot_Pur_Amt	Number	Decimal
Tot_Amt_Paid	Number	Decimal
Outstanding_Amt	Number	Decimal
Table 2: Pur_Bill		
Pur_vr_no [Primary Key]	Number	Long Integer
Pur_vr_Date	Date/Time	Short date
Sup_code Number	Long Integer	
Qty	Number	Decimal
Rate	Number	Decimal

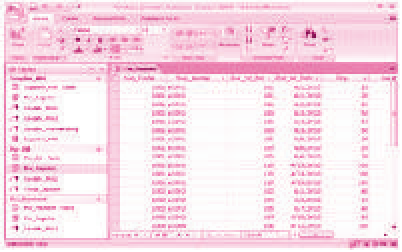




Notes

Bill_Amt	Number	Decimal
Updated	Yes/No	
Table 3: Pur_Payment		
Pay_vr_no [Primary Key]	Number	Long Integer
Pay_vr_Date	Date/Time	Short date
Sup_code Number	Long Integer	
Amt_paid Number	Decimal	
Updated	Yes/No	

Step 2 : Maintain updated Purchase Register

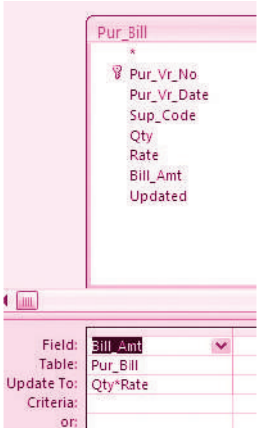


1. Since the purpose is to prepare the updated purchase register for the day, the **Table Supplier_Mst** has to be updated automatically with the occurrence of the every new transaction.

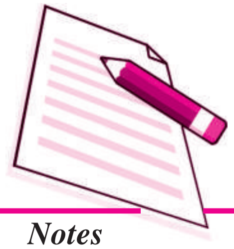
2. Every new transaction is recorded through the Table Pur_bill and has to be updated accordingly for the updation of Supplier_Mst Table. For this, we will be using the query type: UPDATE for the calculation of

   :i. bill_amt *(save the query as 'Value_update'; refer figure-)*

   ii. Outstanding_Amt *(save the query as ' update outstanding'; refer figure)*

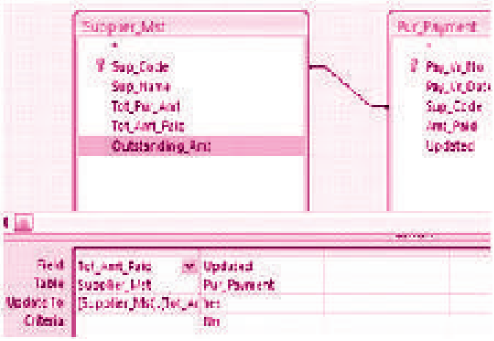


3. [Supplier_Mst].[Tot_Pur_Amt]-[Supplier_Mst].[Tot_Amt_Paid]



Notes

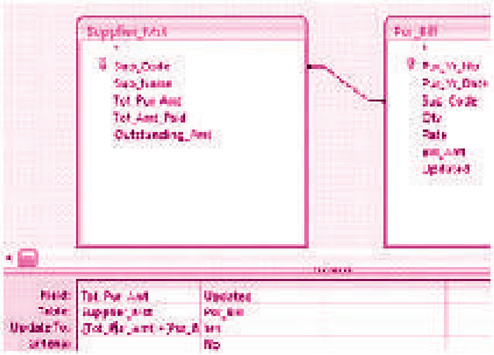
4. Similarly, the Table Pur_payment also updates the Table Supplier_Mst for the outstanding amount due to the suppliers. For this, we will be using the query type: UPDATE as shown in figure—— for the calculation of outstanding amount. The formula used will be:



[Supplier_Mst].[Tot_Amt_Paid] + [Pur_Payment].[Amt_Paid]

(Save the query as Update_Mst2)

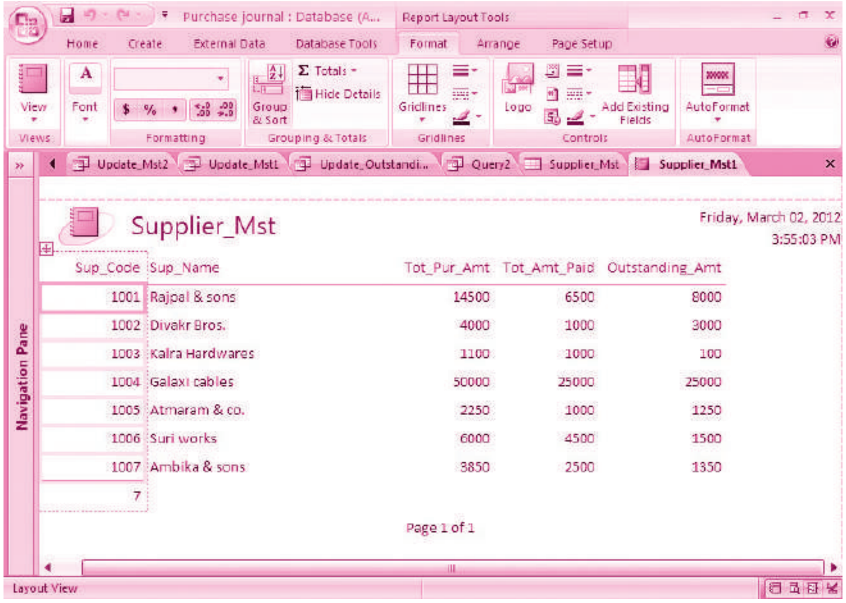
5. Since the Master Table should contain the information of total purchases made by a specific supplier, which in our case is Table Supplier_Mst , we will now create a UPDATE query. The formula used will be:



[Supplier_Mst].[Tot_Pur_Amt] + [Pur_Bill].[Bill_Amt]

(Save the query as Update_Mst1)

In this manner, the purchase book can be generated for a business organisation as shown below:

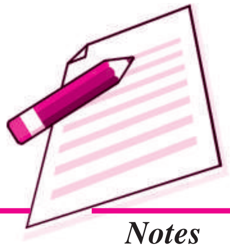


Supplier_Mst

Friday, March 02, 2012
3:55:03 PM

Sup_Code	Sup_Name	Tot_Pur_Amt	Tot_Amt_Paid	Outstanding_Amt
1001	Rajpal & sons	14500	6500	8000
1002	Divakr Bros.	4000	1000	3000
1003	Kalra Hardwares	1100	1000	100
1004	Galaxi cables	50000	25000	25000
1005	Atmaram & co.	2250	1000	1250
1006	Suri works	6000	4500	1500
1007	Ambika & sons	3850	2500	1350
7				

Page 1 of 1



Notes

Skill Review 3

Preparing Sales Register for an organisation

1. Open the database file sales.acdb in the attached CD and enable the content
2. Create the following tables and define fields (as shown in figure—)
3. Generate the Sales Register

Table 1:		
Sup_code [Primary Key]	Number	
Cus_name	Text	25
Tot_sales_Amt	Number	Decimal
Tot_Amt_Recd	Number	Decimal
Outstanding_Amt	Number	Decimal
Table 2: sales_Bill		
sales_vr_no [Primary Key]	Number	Long Integer
sales_vr_Date	Date/Time	Short date
cus_code	Number	Long Integer
Qty	Number	Decimal
Rate	Number	Decimal
Bill_Amt	Number	Decimal
Updated	Yes/No	
Table 3: Sales_Receipt		
receipt_vr_no [Primary Key]	Number	Long Integer
receipt_vr_Date	Date/Time	Short date
cus_code	Number	Long Integer
Amt_recd	Number	Decimal
Updated	Yes/No	

INTEXT QUESTIONS 38.4

Multiple Choice Questions :

i. 'DBMS' stands for :

a) Drawing Board Management Software

b) Dividend Based Marking System

c) Data Base Management System

d) Data base Marking Software

ii. MS Access is a :

a) Word processing Software b) Presentation Software

c) Spread Sheet Software d) Data Base Management Software

iii. The term 'field' as applied to database table means :

a) Vertical column of the table b) Size of the table

c) Horizontal row of the table d) Name of the table

iv. SQL stands for :

a) Simple Questions Language b) Simple Que line up

c) Singular Quantity Loading d) Structured Query Language

v. The default extension of MS Access (2007) file is :

a) .accbd b) .exl c) .doc d) .exe

vi. In order to retrieve select data meeting a specified criteria from two different tables of Access database, we may make use of :

a) Table b) Query c) Form d) Report

vii. To expect a well formatted printable data from Access database, we may use :

a) Table b) Query c) Form d) Report

WHAT YOU HAVE LEARNT

- Database Management System (DBMS) provides a variety of software tools for organising, processing and querying data in a flexible manner.

- In DBMS, data is organised in tables (similar to a file). A table has a number of rows (or records) and columns (or fields or attribute). Each row contains a records of information, for example of an account head or a party or a transactions as per the need. The information in a row consists of a sequence of columns or attributes, such as transaction number, transaction date, etc, or it could be party's name, party's address, etc.
- One of the tasks in analysis of requirement is to identify and list out the information required including its elements. These elements of information become columns (attributes) in appropriate tables.
- Data (set of attributes) should be logically structured so as to put them in various tables. The goal of such structuring is to reduce data redundancy, to achieve data consistency as well as to enhance efficiency for adding, updating and querying operations on database. Data redundancy can be removed by normalisation process.
- Since the data stored in different tables may be related, such relationship is implemented by establishing links between tables. The database created on the basis of such relationships between different tables is called relational database.
- Relationship between tables is established with the help of primary key and foreign key. Primary key consists of minimum possible one or more than one attributes of a table, which uniquely identifies each row of that table. Foreign key consists of set of attributes, which from primary key in another (related) table.
- Most of Computerised Accounting Systems are multi-user systems. These systems use 'server database' unlike single-user (or desktop) systems using 'desktop database'. In a multi user system, a user interacts with the software though the user interface, which is also termed as 'front-end'. Database, which is kept on a server, is termed as a 'back-end'.
- MS-Access is an example of 'desktop database'. Oracle, SQL Server, IBM-DB2 is examples of 'server databases', Desktop databases may be satisfactory for SOHO (Small Office Home Office) organisations as they offer inexpensive and simple solutions to many of business data storage and processing requirements.
- In order to provide security and consistency of data, database is not directly accessible to users. Any addition or retrieval of information from database is done by user-friendly programs. Database is thus rightly referred to as 'back-end' while the interactive program, that includes user interface, is termed as 'front-end' of a database application.

TERMINAL EXERCISE

1. What do you understand by DBMS. Give names of two commonly available DBMS software?
2. With suitable example, illustrate the meaning of 'attributes' as applied to database?
3. Why do we seek to split up information into different tables rather than confine it to a single table?
4. What do you understand by terms 'key field', 'primary key' and 'secondary key' in a database?
5. List the conventions that you will follow, while naming different fields of a table?
6. What are the uses of 'query' object in Access program?
7. What do you understand by 'Form' object in Access and how are they useful?
8. What is the purpose of 'report' object in Access program?
9. What do you understand by database? What are the ways in which data is stored and queried in an Access database?
10. What are the advantages of Access over Excel?
11. Describe in brief the function of 'Table', 'Query', 'Form' and 'Report' object of Access program?

ANSWERS TO INTEXT QUESTIONS

38.1 i. requirement analysis ii. relationships iii. five

38.2 i. queries ii. report object iii. access

38.3 i. 65536 ii. object linking and embedding
iii. Input mask iv. caption

38.4 i. c ii. d iii. a iv. d v. a vi. b vii. d